

Kazakhstan Oil and Gas Tax Guide

By Ernst & Young in Kazakhstan

Introduction

Kazakhstan has world-class oil and natural gas reserves with proven reserves estimated between 9 and 29 billion barrels (1.2 and 3.9 billion tons) of oil and proven natural gas reserves of 65 to 70 trillion cubic feet (1.84 to 1.98 trillion cubic meters).

Kazakhstan is the second largest oil producer among the former Soviet republics after Russia. Kazakhstan is heavily reliant on oil export revenues. Total production in 2005 amounted to approximately 60 million tons of which 52.4 million tons was exported. The Government expects total production to rise to over 3 million bpd by 2010.

The Kashagan discovery in 2000 is considered to be the best oil discovery in the last 30 years, and Kashagan is expected to be the world's largest oil field outside of the Middle East. Since the discovery of Kashagan, interest in the potential of the Kazakh sector of the Caspian has greatly increased.

Another potential area for development of hydrocarbons reserves is the Aral Sea basin. The expected reserves in the Aral basin are estimated to be around 15 billion barrels (2 billion tons) of equivalent fuel. Its high gas and oil potential and favorable geographical situation on the main transportation routes will potentially make the Aral basin one of the priority regions for exploration.

The national oil and gas company KazMunayGas is a vertically integrated oil and gas company that is also responsible for managing the State's interest in Project Sharing Agreements (PSAs).

Oil production

As of January 1, 2005, there were 191 oil fields and 49 condensate fields registered in the Republic of Kazakhstan. The most significant of its existing and prospective fields are Tengiz, Kashagan, and Karachaganak.

Tengiz Field

The Tengiz field, with 6 to 9 billion barrels (0.8 to 1.2 billion tons) of estimated recoverable crude oil

reserves, is operated by Tengizchevroil (TCO). The current equity share structure is as follows:

Tengizchevroil ownership structure:

Owners	Percentage equity share
Chevron (US)	50
ExxonMobil (US)	25
KazMunayGas (Kazakhstan)	20
LUKArco (Russia/US)	5

In 2005 TCO produced 13.6 million tons. According to Chevron, TCO could potentially produce 700,000 bbl/day (34 million tons a year) by the end of the decade.

Kashagan Field

The Kashagan field was discovered in 2000. With re-injection of some of the associated gas, consortium members believe it will be possible that the range of recoverable reserves might be 9-13 billion barrels (1.2-1.7 billion tons), since Kashagan's estimated reserves in place are approximately 38 billion barrels (5 billion tons). The Kashagan owners have agreed to a development plan for the Kashagan field with the Republic and will continue to explore other structures in the North Caspian PSA contract area.

Agip Kazakhstan North Caspian Operating Company (Agip KCO) now acts as Operator.

The North Caspian Consortium's ownership structure:

Owners	Percentage equity share
ENI (Italy)	18.52
Total (France)	18.52
ExxonMobil (US)	18.52
Royal Dutch Shell (UK)	18.52
ConocoPhillips (US)	9.26
KazMunayGas (Kazakhstan)	8.33
Inpex (Japan)	8.33

Karachaganak Field

The Karachaganak field, which is being developed by the Karachaganak Petroleum Operating B.V. (KPO), a joint venture between several western companies led by BG Group and Agip, has estimated recoverable reserves of 2 billion barrels (270 million tons) of oil and gas condensate, as well as 20 trillion cubic feet (570 billion cubic meters) of natural gas reserves.

KPO Ownership structure:

Owners	Percentage equity share
BG Group (UK)	32.5
ENI (Italy)	32.5
Chevron (US)	20
Lukoil (Russia)	15

Caspian Sea Region: Delimitation Issues

Kazakhstan signed agreements on the Caspian seabed delimitation with the Russian Federation in 1998 and with the Republic of Azerbaijan in 2001. Currently, Kazakhstan is continuing negotiations with the Republic of Turkmenistan on Caspian seabed delimitation.

Kazakhstan is a landlocked country. Consequently, transportation costs are high (around USD 6 per barrel to the Mediterranean), and lack of export routes is a potential bottleneck to Kazakhstan's ambitious oil industry development plans.

Oil is exported by the Caspian Sea, by rail cars and by pipelines. Currently, the largest off-take routes are as follows:

Name of the route	Volume of exported oil in 2005, mln tons
Atyrau-Samara	15.175
Tengiz-Novorossiysk (CPC)	30.502
Aktau Sea Port	8.913

Potential export routes

Baku – Tbilisi – Ceyhan Pipeline

The Baku – Tbilisi – Ceyhan pipeline (the BTC) was completed in spring 2006. The pipeline runs for 1,700 km and the expected throughput of the pipeline is 1,000,000 bbl/day (50 million tons a year). This pipeline could eventually carry 500,000 bbl/day from Kazakhstan.

West Kazakhstan – West China Pipeline

The first stage of this project *Keniyak – Atyrau* was complete in spring 2003. The second stage of the project *Atasu – Alashankou* was complete in December 2005. The third stage of this project will be the connection of *Kenkyak and Kumkol*. The expected throughput of the West Kazakhstan – West China Pipeline is 10 million tons per year, with further increase up to 20 million tons per year by 2011.

Kazakhstan – Turkmenistan – Iran Pipeline

This pipeline economically is considered to be the most favorable route for transportation of Kazakh oil to the Persian Gulf terminals. However, it raises complex political issues.

Oil refining in Kazakhstan

Oil refining is an industry that is strictly regulated by the state both through direct administrative measures and through control of transportation tariffs by two national companies – KazMunayGas and Kazakhstan Temir Zholy (Kazakhstan Railways).

Kazakhstan has three major oil refineries supplying the northern region (at Pavlodar), western region (at Atyrau), and southern region (at Shymkent). The refinery at Pavlodar is supplied mainly by a crude oil pipeline from Western Siberia, the Atyrau refinery runs solely on domestic crude from northwest Kazakhstan, and the Shymkent refinery currently uses oil from the fields at Kumkol and Aktobe.

In 2005 processing at the Pavlodar Refinery amounted to 3.72 million tons, while processing at the Atyrau Refinery totaled 3.5 million tons. The oil-processing figure at Shymkent's Petro-Kazakhstan Oil Products refinery totaled 3.9 million tons. By 2012 the expected oil processing in Kazakhstan may reach 18 million tons.

Kazakhstan intends to further develop the oil-refining industry. To this end, beginning 1 January 2004, tax concessions have been introduced for refineries put into use within 2004-2007 provided certain conditions are met.

Gas industry in Kazakhstan

Kazakhstan has sizeable proven natural gas reserves of 65-70 trillion cubic feet (1.84 to 1.98 trillion cubic meters), which is comparable to the reserves of Canada or Kuwait. Most of Kazakhstan's natural gas reserves are located in the west of the country, with roughly 25% of proven re-

serves situated in one field, Karachaganak. Natural gas production in 2005 totaled 26.247 million cubic meters. The country plans to increase its natural gas production to 1.66 trillion cubic feet (47 billion cubic meters) by 2010, and to 1.84 trillion cubic feet (52 billion cubic meters) by 2015.

Sources for this part of our Guide include:

Kazakhstan Statistics Agency, Energy Information Administration (EIA), National Bank of Kazakhstan, Internet Securities, Newsbase, www.mfa.kz, www.kmg.kz, www.agipkco.com, www.cpc.ru, www.portakrau.kz, www.chevron.com.

Taxation of Subsurface Users in Kazakhstan – the Current Regime

Oil, gas, and mining companies in Kazakhstan are referred to as “subsurface users,” and they enter into “subsurface use contracts” to acquire the rights to exploit the mineral resources of the country.

This section describes the tax regime as in force in January of 2006. It is vital to realize that there are many uncertainties in the legislation as it now stands. Consequently, this guide cannot be a substitute for taking professional advice before attempting to model this regime, or to negotiate a contract based upon it.

There are two types of subsurface use contracts, a Production Sharing Agreement (PSA), referred to in the tax legislation as a Model 2 tax regime and the Excess Profit Tax (EPT) type contract referred to as a Model 1 tax regime.

Subsurface Use Legislation

Four major laws in Kazakhstan govern the economic terms established in a subsurface use contract. They are the Subsurface Use Law¹, the Petroleum Law², the Tax Code³, and the PSA Law. The first two of these contain the basic legal framework for the granting, using, and assigning or terminating the rights to be a subsurface user. The PSA Law, which applies only to offshore oil and gas projects, provides the legal regime for PSAs, including a mandatory 50% participation for KazMunayGas. The Tax Code will be discussed in detail below.

Stability of the tax regime

Tax regimes of all subsurface use contracts signed before 1 January 2004 are stabilized.

Tax regimes of PSAs signed after 1 January 2004 are stabilized provided that they have undergone a “tax expert evaluation” — essentially a review by the tax authorities to ensure that the tax terms in the PSA comply with the law in force at the time the PSA became effective.

EPT contracts signed after 1 January 2004 are not stabilized.

Stabilized contracts can be changed by mutual agreement between the parties.

If the subsurface users in a PSA wish to take advantage of a favorable change in the tax regime, they are required to renegotiate the contract to compensate Kazakhstan before they may do so. It appears that there is no equivalent provision for EPT contracts.

Ring-Fencing

The tax regime of a subsurface use contract applies to activities that are carried out within the framework of the contract, and that meet the concept of subsurface use in the subsurface use law. This is generally taken to mean that only production and primary stabilization are within the scope of the contract tax regime.

Accounting

Several subsurface users under a contract are required to maintain consolidated accounts, although generally arrangements can be structured so that they are individually liable for Corporate Income Tax. Each subsurface user is required to maintain separate accounts for activities that are inside the framework of the subsurface use contract, and that are outside it. Generally, accounts should be maintained in accordance with the Kazakh chart of accounts and using IFRS, and the accounting records should be in Russian or Kazakh.

Legislation governing the establishment of tax terms in a subsurface use contract

The Tax Code establishes that only the Tax Code may establish provisions concerning the payment of taxes and levies relating to subsurface operations in the Republic of Kazakhstan. Separate agreements with the government should not do so.

¹ Law No. 2828 of the Republic of Kazakhstan “Concerning the Subsurface and Subsurface Use” of 27 January 1996.

² Law No. 2350 of the Republic of Kazakhstan having the force of Law “Concerning Petroleum” of 28 June 1995.

³ Code of the Republic of Kazakhstan “Concerning Taxes and Other Obligatory Payments to the Budget” of 12 June 2001 effective from 1 January 2002.

Taxes Applicable to Subsurface Users

The taxes applicable to subsurface users are as follows:

Applicable taxes	Model 1 (EPT)	Model 2 (PSA)
1. Special taxes and payments of subsurface user:		
Bonuses	Yes	Yes
Royalty	Yes	No
Excess profits tax	Yes	No
Share of the production	No	Yes
Additional payment under PSA "Top Up Tax"	No	Yes
2. Other taxes and obligatory payments to the budget, including:		
Rent tax on export of crude oil and gas condensate	Yes	No
Excise on crude oil and gas condensate	Yes	No
Land tax	Yes	No
Property tax	Yes	No
Environmental fees	Yes	Yes
Other fees (e.g. fee for the use of radio frequency spectrum, fee for the use of navigable waterways)	Yes	Yes
Other taxes and payments	Yes	Yes

Bonuses

General provisions concerning bonuses

Bonuses are fixed payments of subsurface users. The subsurface users are expected to pay two types of bonuses:

- 1) Signature bonus;
- 2) Commercial discovery bonus.

In the past, many contracts established production bonuses that were payable when certain production levels were reached. These are no longer included in contracts negotiated after 1 July 1998, as the production bonuses are essentially no different than royalties, and were deleted by legislative changes.

Signature bonus

The signature bonus is a lump-sum payment by a subsurface user for the right to use subsurface.

The initial amounts of signature bonuses are defined by the Government of the Republic of Kazakhstan based on the volume of mineral resources

and economic value of the field. The final amount of a signature bonus is established by a commission at the conclusion of a Tender of investment programs held to award the right to use of the subsurface, and is included in a contract taking into account the economic value of fields (contract territories) covered by the contract, but cannot be lower than the initial amount set by the Government.

The signature bonus should be paid to the budget no later than 30 days from the date when the contract comes into force. The tax return is to be filed by the 15th day of the month following the month of payment due.

Commercial discovery bonus

The commercial discovery bonus is a fixed payment that is paid by subsurface users when a commercial discovery is made on the contract territory.

Under contracts for the exploration of fields of mineral resources that do not include the subsequent production of those minerals, the commercial discovery bonus is not paid. The base for calculation of the commercial discovery bonus is defined as the value of the extractable minerals duly approved by the competent state authorities. The value of the mineral resources is determined using the market price established at the International (London) Exchange, in accordance with the information sources approved by the Government of Kazakhstan, for the given mineral resource on the day bonus payment is made. When a market price for mineral resource is not established, the value of extractable minerals is determined based on the planned costs of their extraction adjusted by the planned profitability as indicated in the work program approved by the competent authority. From 1 January 2004, the rate of commercial discovery bonus is fixed at 0.1 % of the value of proven extractable resources. Previously, the rate of commercial discovery bonus was not fixed, i.e. it could vary depending on the specific conditions of subsurface use operations but could not be lower than 0.1 %. The payment is due within 90 days from the competent authority approving the volume of extractable minerals from the deposit. The tax return is due by the 15th day of the month following the month of payment becoming due.

Royalties

A separate royalty regime applies to each type of mineral resources produced in the contract area. Royalties are normally paid in cash unless the Go-

vernment of the Republic of Kazakhstan specifically requires payment in kind. If payment is to be in kind, the mechanism should be set out in an additional agreement with the competent authority. Cash royalty payments will usually be calculated by multiplying the production by a netted back price and applying the appropriate royalty rate.

The 2005 amendments to the Tax Code subjected a new type of subsurface use activity, construction and/or operation of underground structures (e.g. pipelines and oil & gas storage facilities), to royalty. In particular, when the subsurface is used for construction and/or operation of underground constructions not associated with exploration and/or production, royalties are paid by the subsurface user for the volume of mineral resources to be extracted from the subsurface during the construction of the underground structures, and also for the area occupied by these structures in the subsurface. It would appear that this would apply to, for example, a buried pipeline.

Royalties are calculated on the value of the produced mineral resources. For hydrocarbons this value is calculated on the basis of the average selling price in the reporting period, exclusive of indirect taxes, and reduced by the actual transportation expenses to the place of sale (shipment).

The rates of royalty applicable for the area occupied by the structures in the subsurface are to be established by a separate legal act of the Government, which has not been adopted yet.

The 2004 amendments to the Tax Code introduced a sliding scale of royalty rates for oil and associated gas. The royalty rate depends on the volume of accumulated oil production, including gas condensate, for each calendar year. The 2005 amendments made changes to the rates and tax brackets for royalty, which will appear to negatively affect medium-size producers.

Volume of accumulated oil production, including gas condensate, for each calendar year (thousand tons)	Royalty rate
Up to 500	2%
From 500 to 1,000	2.5%
From 1,000 to 1,500	3%
From 1,500 to 2,000	3.5%
From 2,000 to 2,500	4%
From 2,500 to 3,500	4.5%
From 3,500 to 4,500	5%
From 4,500 to 5,000	5.5%
More than 5,000	6%

The treatment of a pure gas fields remains unclear, but it may be inferred that the royalty calculation should be similar to the one for associated gas hydrocarbons.

For purposes of the royalty calculation, associated gas hydrocarbons should be converted to their crude oil equivalent at the ratio of 1,000 m³ to 0.857 ton of crude oil. Moreover, gas hydrocarbons are also valued in the case of free-of-charge transfer for further processing. The value will be based on actual costs of production and primary processing increased by actual rate of return for the tax period. The Tax Code also has separate provisions establishing the procedure for determining royalty base in some specific cases.

The Tax Code also establishes royalty rates for commonly occurring minerals. For minerals other than oil, gas condensate, and commonly occurring minerals, royalty rates are negotiated by the parties and further fixed in a relevant subsurface use contract.

The 2005 amendments have also clarified that if gas hydrocarbons are re-injected in the subsurface, such gas hydrocarbons are exempt from royalty.

Royalties must be paid by the 15th day of the month following the reporting period, which may be a calendar month or a quarter depending on the volume of royalty payments to the budget. The tax return should be filed no later than the 10th day of the month following the reporting period.

Economic rent tax on oil for export

Starting from 1 January 2005, the economic rent tax on crude oil for export has officially stopped being a special payment of subsurface users and has acquired the full status of a regular tax applicable to defined taxpayers having a taxable object. Although strictly speaking starting from its introduction in 2004, the tax was applicable to entities other than subsurface users. The amendment effective in 2005 made this fact more evident.

Another important change is that export of gas condensate is now also subject to economic rent tax.

The payers of the economic rent tax are legal entities and individuals making sales for export of crude oil and gas condensate. PSA contract holders are exempt from it in respect of production from their own contract areas. The tax base is determined as the value of the exported crude oil based on the market price netted back for transportation costs and for quality of oil. The procedure for determining market prices for oil, gas conden-

sate is determined in the Resolution of the Government of Kazakhstan of 25 August 2005 as the simple average of daily quotations of Urals Mediterranean and Dated Brent in the tax period published in Platt's Crude Oil Marketwire by McGraw-Hill Companies Inc. The tax rates applied to exported crude oil and gas condensate vary as follows:

Market price (USD/bbl)	Rate
Less than 19	0 %
From 19 to 20	1 %
From 20 to 21	4 %
From 21 to 22	7 %
From 22 to 23	10 %
From 23 to 24	12 %
From 24 to 25	14 %
From 25 to 26	16 %
From 26 to 27	17 %
From 27 to 28	19 %
From 28 to 29	21 %
From 29 to 30	22 %
From 30 to 31	23 %
From 31 to 32	25 %
From 32 to 34	26 %
From 34 to 36	28 %
From 36 to 37	29 %
From 37 to 38	30 %
From 38 to 40	31 %
More than 40	33 %

The tax period of economic rent tax on oil for export is a calendar month, and the deadline for submission of a tax declaration is the 15th of the month following the reporting month. The tax is payable by the 15th day of the month following the reporting month.

Excess profit tax

Subsurface users operating under a Model 1 contract are subject to excess profit tax in accordance with the procedure and at the rates established below.

The procedure for calculation of excess profit tax has changed significantly starting 1 January 2004. Prior to that date, it was a conventional IRR-based calculation. Under the current regime, the tax base is the net income of a subsurface user in excess of 20% of tax deductions.

The amendments to Tax Code effective from 1 January 2005 introduced a new triggering point into EPT rate calculation. The EPT will start to apply once the ratio of cumulative aggregate income to cumulative tax deductions (as calculated for

corporate income tax purposes) exceeds 1.2. A definition of net income for the purposes of EPT was also introduced to the Tax Code. It is defined as the difference between taxable income and corporate income tax (plus branch profits tax where applicable).

The tax base can be adjusted for expenditures actually incurred for the education of the Kazakhstani work force and/or increase of fixed assets but not exceeding 10% of the taxable amount.

The tax rates are established on a sliding scale ranging from 0% to 60% and now depend on the ratio of accumulated income to accumulated expenses of a subsurface user. Excess profit tax is paid separately with respect to each subsurface use contract.

Excess profit tax is calculated by multiplying the tax base by the rates established below:

Ratio of Accumulated income to Accumulated expenses	Excess profit tax rate
Up to 1.2	0 %
From 1.2 to 1.3	10 %
From 1.3 to 1.4	20 %
From 1.4 to 1.5	30 %
From 1.5 to 1.6	40 %
From 1.6 to 1.7	50 %
More than 1.7	60 %

Below is a sample EPT calculation under the current tax regime.

Line #	Description	Example 1	Example 2
Assume:			
1	Accumulated income, USD	1,200	1,400
2	Accumulated expenses, USD	1,000	1,000
3	Ratio of accumulated income to accumulated expenditures	1:2	1:4
4	Sales Income for a tax year, USD	100	100
5	Deductible Costs for a tax year, USD	70	30
6	Taxable Income, USD	30	70
7	CIT, USD	9	21
8	Net Income, USD	21	49
Then:			
9	20% of deductions, USD (line 5 times 20 %)	14	6
10	Tax base, USD (line 8 less line 9)	7	43
11	EPT rate (in accordance with Article 308)	10	30
12	EPT amount, USD	0.7	12.9

The tax period of EPT is a calendar year, and the deadline for submission of a tax declaration is 10 April of the year following the reporting year. The tax is payable by 15 April of the year following the reporting year.

Share of the Republic in profit production

The Tax Code specifically provides for the following provisions that must be included in a PSA:

- 1) Determination of the volume and monetary value of total production;
- 2) Determination of the percentage of total production to be used for cost recovery, i.e. to reimburse the costs incurred by the subsurface user (cost recovery production);
- 3) Determination of the share in total production to be shared after deduction of the cost recovery production between the subsurface user and the Republic of Kazakhstan (profit production);
- 4) The shares (percentages) of the share of the Republic of Kazakhstan and the subsurface user's share in profit production;
- 5) The procedure for determining the share of the Republic of Kazakhstan in profit production in accordance with the Tax Code.

The tax period for payment of the share of the Republic of Kazakhstan under the production sharing is set as a calendar month. The share of the Republic must be paid no later than the 15th of the month following the tax period. The declaration on the share of the Republic in profit production should be submitted to the tax authorities by the 10th of the month following the reporting month.

Valuation of total production

Starting from 2005 the Tax Code provides for the method of valuation of *extracted production* substituting all provisions of valuation introduced in 2004.

The value of extracted production is determined as the product of the physical volume of extracted production in tons as measured at the point of sharing (to be determined by a specific PSA) and the average sales price at the point of sharing for the tax period in question. The average sales price of production is determined as the total sales income for the reporting period less indirect taxes and sale and transportation expenses divided by the corresponding physical volume sold. The sales price is also subject to transfer pricing control under the transfer pricing law.

Cost production

The Tax Code provides for a list of expenses that are recoverable under a PSA. Recoverable expenses are defined as "justified" expenses of a subsurface user actually borne during the execution of the work program and without any uplift. There is no definition of "justified," but clearly issues such as whether the expense is part of an approved work program, and is supported by proper documentation will be important. The share of production allocated to cost recovery may not exceed 75% prior to payback and 50% post payback.

Recoverable expenses include all of the following unless explicitly disallowed for cost recovery (please see a separate list below):

- 1) Expenses actually borne by the subsurface user prior to signing of the contract:
 - expenses on preparation and development of the project's feasibility study during the stage preceding the conclusion of the contract;
 - expenses on prospecting, appraisal and exploration works related to the project and performed before the contract comes into force;
- 2) Expenses actually borne by the subsurface user from the date when the contract comes into force and during the period of its validity.

Administrative expenses relating to the execution of a contract (which include expenses for the payment of office rent of the subsurface user, including those offices outside the territory of the Republic of Kazakhstan, expenses for their maintenance, information and consultation services, representative expenses, advertising expenses, and other administrative expenses under the conditions of a contract) shall be refunded according to the standard established by the contract, and are deductible within 1% of the total amount of recoverable expenses of the subsurface user in a reporting period.

The Tax Code also provides for the list of specific expenses that are not cost-recoverable for subsurface users operating under Model 2 tax regime.

Non-recoverable expenses include:

- expenses on the payment of a fee for participation in tenders for subsurface use rights;
- expenses on the purchase of geological information;

- expenses in excess of the limits established by the contract, including those related to administrative expenses;
- expenses on the payment of the fee for pollution of the environment exceeding established limits
- expenses related to the sale of the cost production and part of profit production owned by the subsurface user, including expenses on the transportation of this production from the point at which the subsurface user received ownership to the sale point, losses during transportation, transportation insurance expenses to the sale point, commission fees and other expenses;
- expenses related to the audit of the activities performed at the request of owners;
- expenses incurred as a result of failures in performance by the subsurface user of the responsibilities stipulated in the contract (including the expenses arising from the breach by a subsurface user of its contractual obligations with respect to local content requirements);
- expenses related to excursions and traveling;
- expenses on payments of interest on loans and for use of borrowed funds;
- losses incurred due to accidents caused by a subsurface user, as a result of a failure to observe technology and safety measures;
- expenses from social projects;
- expenses for the voluntary insurance of employees;
- costs incurred in connection with legal proceedings;
- fines and interest penalties imposed by any state bodies on a subsurface user;
- costs relating to the payment of expenses to be used for the personal needs of employees, which are not stipulated by legislation of the Republic of Kazakhstan;
- bonuses;
- taxes and obligatory payments paid to the budget;
- other expenses not related to the activity under the contract.

Recoverable expenses of the subsurface user are reduced by:

- the amount of operating income, related to receipt of rent payments for rental of property created or acquired under the contract after deduction of related expenses;
- the amount of other income (penalties, interest, etc.) received from activity under the contract.

Triggers to determine the Sharing of Profit Production

For all new PSAs (i.e. concluded after 1 January 2004) the share of the subsurface user in profit production is determined as the lowest of three percentage values given by the following three triggers (discussed further below in greater details):

- 1) R-factor (profitability index) – the ratio of subsurface user’s accumulated income to accumulated expenditure under the project;
- 2) Internal rate of return (IRR) of contractor – discount rate when net real discounted income (presumably net present value) reaches its zero value;
- 3) P-factor (price factor) – ratio of subsurface user’s income to the total production volume during the reporting period.

For the purpose of calculating triggers, the term “deflated” or “real” signifies the amount calculated taking into account 1/12 of the average inflation index for the reporting period of the project. It is likely that to this end the average of three inflation indices are used: inflation index for consumer basket, for industrial sector, and for service sector.

It will be seen from the tables below that the triggers move quite rapidly from maximum investor take to minimum take.

Note that the tax period is a calendar month, and a deadline for submission of a tax declaration is the 10th of the month following the reporting month. The share of the Republic is payable by the 15th day of the month following the reporting month.

An additional floor on the State’s share in the split of profit production will apply when “conditions of a production-sharing contract realization deteriorate,” which is a rather ambiguous statement, which has yet to be clarified. In this event, the profit production share of the Republic would not be lower than “its maximum amount fixed prior to the deterioration unless such maximum amount was reached due to P-factor trigger when calculating the profit production of a subsurface user.”

R-factor

The R-factor is the ratio of accumulated income to accumulated expenditure under the project. Income accumulated under the project is calculated as:

- Real (i.e. deflated) aggregate value of the subsurface user's cost recovery production
- Plus** Real aggregate value of the subsurface user's profit production
- Less** Real aggregate income tax paid to the budget.

Expenditure accumulated under the project includes recoverable expenses (as defined above) and expenses that are not cost recoverable but are deductible expenses for corporate income tax purposes. The total expenditure is calculated as:

- Real aggregate recoverable operating expenses
- Plus** Real aggregate recoverable exploration and appraisal expenses
- Plus** Other real aggregate recoverable expenses of subsurface user
- Plus** Other real non-cost-recoverable aggregate expenses deductible for corporate income tax purposes by the subsurface user.

Both income and expenditure will be determined on an accrual basis. Based on the R-factor calculated as above, the share of the subsurface user is determined as follows:

R-factor	Subsurface user's share of profit production (%)
Less or equal to 1.2	A%
More than 1.2 USD less than 1.5 USD	$A\% - (A\% - 10\%) / 0.3 \times (R\text{-factor} - 1.2) \times 100\%$
More or equal to 1.5	10%

The value of A% may be determined in each particular PSA and may range from 70% to 90%.

IRR

IRR is the annual real discount rate at which the net present value (NPV) of the project is zero. NPV is calculated based on the discounted deflated cash flows for each reporting period (a calendar month) starting from the effective date of the PSA. The proposed changes do not explain how IRR is to be calculated (i.e. as a monthly

rather than annual amount, and how current tax liabilities are to be included) and how monthly and annual amounts co-relate. Presumably, the annual discount rate (IRR) will be calculated via compounding as $(1 + \text{monthly discount rate})^{12} - 1$.

The deflated cash flow for a reporting period is calculated as the difference between the deflated values of cost recovery and profit production of the subsurface user and the deflated values of its costs. The costs include operating, exploration and appraisal, development recoverable expenses, taxes and obligatory payments (e.g. environmental fees, top-up tax) paid within the reporting period i.e. a month (except for the Republic's share of production), commercial discovery bonus, part of signature bonus related to a particular development area paid in the reporting period. Similarly to the R-factor, for IRR purposes, it appears that recoverable expenses include both recoverable costs for cost recovery purposes and deductible costs for CIT purposes that have not been included into recoverable costs.

Once IRR is calculated as above, the share of the subsurface user is determined as follows:

IRR	Subsurface user's share of profit production (%)
Less or equal to 12%	A%
More than 12% less than 20%	$A\% - (A\% - 10\%) / 8\% \times (IRR - 12\%)$
More or equal to 20%	10%

The value of A% may be determined in each particular PSA and may range from 70% to 90%.

P-factor

P-factor (price factor) will be calculated as the ratio of the sum of deflated cost recovery production and subsurface user's share of profit production for the reporting period to the volume of "oil" produced during the reporting period.

Depending on the P-factor calculated as above, the share of the subsurface user is determined as follows:

P-factor	Subsurface user's share of profit production (%)
Less or equal to 12 USD per barrel	A%
More than 12 USD less than 27 USD per barrel	$A\% - (A\% - 10\%) / 15 \times (P\text{-factor} - 12) \times 100\%$
More or equal to 27 USD per barrel	10%

The value of A% may be determined in each particular PSA and may range from 70% to 90%.

ronment as determined by legislative acts of the Republic of Kazakhstan. Special uses of the natural environment can only be carried out on the basis of a permit issued by the authorized body for the protection of the environment.

The object of taxation is the actual volume of emissions within and (or) in excess of the established limits and discharges (including accidental) of pollutants and of the disposal of production and consumption waste.

The rates of the fee are established by local representative bodies on the basis of and not lower than calculations made by the authorized body for the protection of the environment.

The fee is paid to the budget at the location of the source (object) of pollution of the environment indicated in a permit, with the exception of movable sources of pollution for which payments are made to the budget at the place of their state registration by the authorized body.

The procedure of processing the documentation and obtaining a permit for special use of natural environment is different for the following regions:

- Space complex Baikonur
- Caspian Sea
- Irtysh river
- Ural river
- Tobol river
- Ili river
- Syrdaria river.

In particular, while for all other regions the processing of the documentation prior to issuing a permit is conducted on the local level (i.e. on the level of city or oblast), for the above regions both processing the documentation and issuing a permit is conducted by the central body responsible for protection of the environment. Please note, however, that definitions, for example, of the "Caspian Sea" region are not provided.

Other fees

Besides the environmental fees, a subsurface user may also be subject to other fees and charges depending on the actual nature of its activities. Below are the examples of such additional fees.

The fee for the use of the radio frequency spectrum

The fee is collected for nominal frequencies (bands, ranges) of the radio frequency spectrum. The right to use the radio frequency spectrum

must be certified by authorization documents issued by the authorized body for communications in accordance with the procedure established by legislation of the Republic of Kazakhstan.

Nominal frequencies of the radio frequency spectrum may be allocated on a competitive basis in accordance with legislation of the Republic of Kazakhstan. The winner of a competitive tender should make a one-off payment (similar to signature bonus) to the state budget in accordance with the procedure established by legislation of the Republic of Kazakhstan.

The fee is calculated by the authorized body for communications in accordance with the technical parameters specified in authorization documents and on the basis of annual rates depending on the type of radio communication and the territory in which the radio frequency spectrum is used.

The fee is paid to the budget of main tax registration of a taxpayer.

The fee for the use of navigable waterways

The fee is collected for the use of navigable waterways of the Republic of Kazakhstan. The right to use navigable waterways of the Republic of Kazakhstan is granted by an authorization document issued by the authorized body for transportation control for each calendar year. In the absence of the appropriate authorization document, the basis for the collection and payment to the budget of the fee is the actual use of navigable waterways of the Republic of Kazakhstan.

The rates of the fee are established by the Government of the Republic of Kazakhstan.

The fee is paid to the budget where use of the navigable waterways takes place.

In addition to the taxes and fees highlighted above, a number of additional fees and charges exists in the Tax Code. We list the ones that may be most relevant to subsurface users.

- Levy for the state registration of legal entities.
- Levy for the state registration right to immovable property and transactions relating to it.
- Levy for the state registration of radio-electronic and high frequency devices.
- Levy for the state registration of mechanical modes of transport and trailers.

- Levy for the state registration of marine, river, and small vessels.
- Levy for the state registration of civil aircraft.
- Levy for the passage of motor vehicles through the territory of the Republic of Kazakhstan.

Overall, in light of the increased attention on behalf of the Government to environmental protection, the environmental fees and non-tax payments in general may become a significant part of the overall tax take for a subsurface user. In addition, obtaining approvals of various authorized bodies for use of certain natural resources requires significant time and involvement on behalf of a taxpayer. Therefore, when planning its activities in Kazakhstan, a subsurface user needs to pay closer attention to such fees.

Project Economics

To model the economic effect of the subsurface tax regime effective 1 January 2006, we have created a hypothetical set of project data that might apply to a new Caspian offshore project, summarized as follows:

- Oil price – 40 USD/barrel in 2006 money;
- Recoverable reserves – 742 million barrels;
- Exploration expenditures – 0.116 USD/barrel;
- Development expenditures – 3.354 USD/barrel;
- Operational expenditure – 2.864 USD/barrel;
- Transport 6 USD/barrel;
- Signature bonus – 50 mln USD;
- Project life – 28 years;
- Inflation – 2%;
- Effective income tax rate 33.5% (30% CIT and 5% branch profits tax as reduced by a typical double tax treaty).

The results using this data set for a PSA and an EPT contract under the 2006 regime are as follows:

	PSA	EPT
Real IRR	From 15.98% to 20.19%	22.13%
NPV 10% real (USD mill)	From 338 to 820	1033
State share of project rent at 10% real	From 82% to 93%	79%

Taxation of Business Profit

In addition to the taxes outlined above, the business profits of a subsurface user are taxed as follows⁴:

Corporate income tax

The corporate income tax rate is 30% of taxable income. Taxable income is calculated as the difference between aggregate annual income (after certain adjustments) and statutory deductions.

Deductions

All expenses related to generation of aggregate annual income are deductible for corporate income tax purposes. The examples (without limitation) of expenses that are allowed for deduction can be found below:

- Interest expense (within limits);
- Contributions to Decommissioning Fund. The procedure for making such contributions and the amount are to be established in the subsurface use contract;
- Expenditures on geological studies and exploration and preparatory operations for extraction of mineral resources;
- Expenditures on Research & Development and scientific and technological works.

Geological studies and exploration and preparatory operations for production of useful minerals include the following: appraisal, preparatory work, general and administrative expenses, and costs associated with the payment of the bonuses. These costs together with expenditures on purchase of fixed assets and intangible assets (expenditures incurred by a taxpayer while acquiring the right to geological exploration, development, or extraction of mineral resources) form a depreciation group separate from fixed assets for tax purposes and may be deducted by declining balance depreciation at the rate not exceeding 25%. Similar expenses incurred after the separate depreciation group has been formed (potentially it means that expenses were incurred after depreciation starts) are included into the group to increase its balance value.

An important amendment was introduced into the 2005 Tax Code. The amendment clarifies

⁴ Please note that Ernst & Young Kazakhstan publishes a separate brochure (Kazakhstan: a Business and Investment Guide) describing taxation of business profit and indirect taxation in more detail.

the point in time when the pool of geological prospecting and preparatory operations expenses starts to be depreciated. In particular, it is clarified that the depreciation begins once production following a commercial discovery starts. This implies that proceeds from sale of pilot production will be immediately taxable, since capitalized exploration costs would not be available to offset the net profit on an extended well test.

In the case of farm-in, the subsurface user is allowed to capitalize the cost of acquiring a subsurface use right. Upon farm-out, the subsurface user is liable for tax on capital gains.

The following are examples of other deductible expenses:

- Foreign exchange losses when a foreign exchange loss exceeds a foreign exchange gain;
- Expenses on social payments to employees;
- Insurance premiums except for insurance premiums paid according to accumulative insurance contracts;
- Amounts paid as redemption of doubtful payables previously written off as income;
- Doubtful receivables not redeemed within three years;
- Taxes paid (except for the taxes already excluded prior to determining aggregate annual income, income tax paid in the territory of the Republic of Kazakhstan and in any other states, and the tax on excess profit);
- Fines and penalties, except for those payable to the state budget;
- Maintenance or current repair expenses;
- Capital repair (within the statutory limits).

The Tax Code also provides for certain expenses to be deducted directly from the taxable income within 3% of the taxable income. Below are examples of such expenses:

- Charitable contributions to the State's social infrastructure: orphanages, handicapped organizations, and others;
- Sponsor aid (subject to certain conditions);
- Expenditures actually incurred by a subsurface user with respect to training Kazakhstan personnel and the development of the social sphere of rural areas, within amounts stipulated in the subsurface use contracts.

Losses pertaining to subsurface use contracts may be carried forward for up to seven years.

Depreciation

From 1 January 2006, for tax depreciation purposes fixed assets are split into four groups (instead of the previously existing nine groups each having several subgroups) depreciated at the applicable maximum depreciation rates as below:

Group #	Type of fixed assets	Maximum depreciation rate (%)
I	Buildings, structures (except for oil and gas wells and transmission devices)	10
II	Machinery and equipment, except for machinery and equipment of oil and gas production	25
III	Office machinery and computers	40
IV	Fixed assets not included into other groups	15

Branch profits tax

In addition to corporate income tax, the permanent establishment of a foreign legal entity is subject to a branch profits tax of 15%, levied on net income after corporate income tax – i.e. an aggregate tax burden is 40.5% of taxable income.

Double tax treaties may reduce the amount of branch profits tax to 5%.

Indirect Taxation

Value-Added Tax

Crude oil, natural gas, and gas condensate sold in the territory of Kazakhstan are subject to 15% VAT. Export sales of crude oil, natural gas, and gas condensate are subject to zero-rated VAT.

Under the Tax Code, international transportation services (including transportation of oil and gas via trunk pipelines) are subject to zero-rated VAT.

Imports of goods and equipment are subject to 15% import VAT. The Government has also established a list of certain goods and equipment that may be imported pursuant to a special procedure that effectively results in no import VAT being paid (usually referred to as the "offset" mecha-

nism). The list is updated from time to time. Currently some oil and gas equipment is included on this list. The list is limited to items not readily available within Kazakhstan.

In September 2004, Protocol to the *Treaty between the Governments of Russia and Kazakhstan on Collection of Indirect Taxes in Mutual Trade* has been signed. As a result, starting from 1 February 2005 export of natural gas, crude oil, and gas condensate to Russia is taxed at the zero rate of VAT in Kazakhstan similarly to export of any other goods from Kazakhstan to Russia.

Geological prospective exemption

Geological prospecting is exempt (without a credit for VAT suffered) from VAT. Geological prospecting is defined as a complex of works that are inter-related, performed in a certain sequence, and are aimed at prospecting, exploration, appraisal, and preparation of hydrocarbon or mineral deposits for exploitation. An exemption is applied in relation to geological prospecting and geological exploration work conducted by a taxpayer (contractor, sub-contractor) within the framework:

- 1) of a contract for subsurface use concluded in accordance with legislation of the Republic of Kazakhstan:
 - to conduct exploration work on subsurface plots (geologic draw-offs);
 - to conduct work relating to the joint exploration and extraction on subsurface plots (geologic draw-offs) during the exploration stage;
- 2) an agreement concerning state procurement of work for the geological study of the subsurface.

A list of the specific types of geological prospecting and geological exploration work, certain types of special work that are a significant part of geological prospecting and geological exploration work, and their volume and value should be specified in a project's work program for each geological (scientific and geological) block, based on the aims of the study and the specific characteristics of the geological block, scientific and technical capabilities, the geological and methodological requirements for the performance of geological exploration and prospecting work, and the requirements for the protection of the subsurface and the environment. The tax

authorities consider that the exemption should apply only to subcontractors working directly for subsurface users. In practice, it is very difficult to precisely forecast and describe all possible work/services in the work program for a project in advance, although the tax authorities do appear to recognize this practical difficulty.

Place of Supply Rule

The applicability of Kazakh VAT is determined based on the deemed place of supply of a given turnover. It is important to note that under the place of supply rules, a service may be physically performed outside of Kazakhstan, but deemed to be supplied inside Kazakhstan for VAT purposes. For example, a supply of a service related to immovable property located in Kazakhstan, or a consulting service performed outside of Kazakhstan for a customer inside Kazakhstan. Where the place of supply is deemed to be outside of Kazakhstan, the underlying turnover is not subject to Kazakh VAT. The rules determining the place of supply are generally as follows:

For goods:

- Place where transportation commences if goods are transported or mailed;
- Otherwise, place where goods are transferred to the purchaser (it is not clear whether this involves a physical transfer or a transfer of rights).

For works and services:

- Place where immovable property is located for works and services directly related to such property;
- Place where works and services are actually carried out for works and services related to movable property;
- Place of business or any other activity of the customer for the following works and services: transfer of rights to use intellectual property, consulting services, audit services, engineering services, legal services, accounting services, attorney's services, advertising services, data processing services, rent of movable property (except for rent of motor vehicles), supply of personnel, communication works and services, etc.;

- Otherwise, the place of business or any other activity of the service provider.

Sales of goods or services that are merely auxiliary to a principal sale will be deemed to take place wherever the principal sale takes place. No definition of auxiliary sales is provided in the tax legislation.

Customs Duties

The Customs Code⁵ provides that customs exemptions for goods imported for the own needs of subsurface users operating under subsurface use continue to apply if the contracts were concluded before the new Customs Code came into force. The exemption is applied provided it is built into such contracts. In particular, such goods were exempt for subsurface use contracts concluded between April 1998 and when the new Customs Code came into force. Such goods are still subject to customs clearance fees. It is not clear whether these are "grandfathered," though arguably they are not, in which case the rates of the customs clearance fee apply as recently established by the Government of the Republic of Kazakhstan: 50 Euro for the main page of the customs declaration and 20 Euro for each additional page.

For goods that are not imported for the own needs of subsurface users operating under "grandfathered" subsurface use contracts, customs duties will normally apply at rates ranging from 0% to 30%. The import of most oil and gas equipment will be subject to customs duties between 5% and 10%. Equipment imported for exploration activities will often be exempt from customs duties.

The customs legislation provides for a temporary import regime that either exempts goods and equipment from customs duties and import VAT or allows for partial payment provided these goods and equipment will be re-exported.

Excise tax on petroleum products or importation

Crude oil and gas condensate is subject to excise tax at the moment of their sale or upon their transfer to a refinery. The rate of excise tax for domestically produced as well as imported crude oil and gas condensate is currently set at zero.

The following rates of excise tax apply to domestically produced and imported petroleum and petroleum products:

Products	Excise tax per ton*	
	Domestically produced, in KZT	Imported, in Euro
Petrol	500-5,000 (USD 4.2 – 42.2)	23
Diesel fuel	60-600 (USD 0.5 – 5)	0
Crude oil, including gas condensate	0	0

* This table is effective as of 1 July 2006 (exchange rate of 118.41 tenge/USD).

Other Taxes

Property Tax

Property tax is calculated as 1% of the average residual book (not tax) value of depreciable assets per annum other than vehicles and land.

Land Tax

Land tax varies from KZT 0.48 (USD 0.004) to KZT 5,790 (USD 49) per hectare depending on land quality and purpose.

Vehicle Tax

Most vehicles are subject to tax according to established rates. Tax on vehicles is paid annually and computed based on monthly computation indices. The monthly computation index currently equals KZT 1030 (USD 8.7). The tax ranges from 1 times the MCI (USD 8.7) to 117 times the MCI (USD 1018) per year depending on technical characteristics of the vehicle.

Transfer Pricing

Under the Law on Transfer Pricing, starting January 2001 transfer pricing regulations apply to the following cross-border transactions:

- transactions between mutually dependent or interrelated parties;
- barter transactions;
- transactions involving offset of counter claims of a similar nature (including cession of claims);

⁵ The Customs Code of the Republic of Kazakhstan of 5 April 2003 effective from 1 May 2003.

- transactions with persons registered (residing) or having bank accounts in foreign countries, the legislation of which does not require disclosing and submitting information when conducting financial transactions, or in which a preferential taxation regime is applied, including offshore zones;
- transactions with legal entities that enjoy tax exemptions or apply tax rate, which differs from the rate established by the tax legislation; or
- transactions with legal entities which have tax losses for the last two tax periods preceding the year of the transaction.

Other cross-border transactions are subject to transfer pricing regulations if the transaction price differs from the market price by more than 10 percent.

The last two bullet points mentioned above will also be applicable to onshore transactions, provided that such transactions are connected with cross-border transactions, which are defined as import/export transactions with respect to goods, works and services.

In order to exercise the transfer pricing rules, the tax authorities monitor certain types of trans-

actions. The list of such transactions is established by a special resolution, which among others includes transactions in respect of crude oil, natural gas, and refined products. The government has also issued a list of companies registered for tax purposes in Kazakhstan, which are subject to transfer pricing monitoring. However, transfer pricing control is not necessarily limited by these lists.

If the tax authorities are not able to determine the market price, they may use the cost-plus or resale-minus method.

On the basis of transfer pricing adjustments, the tax authorities may assess:

- Principal income tax;
- Principal VAT and excise tax, if applicable;
- Principal royalties, Republic's share of production and excess profits tax (for subsurface users);
- Principal customs payments
- and related penalties and interest.

Transfer pricing provisions stipulated in international agreements ratified by Kazakhstan prevail over the Transfer Pricing Law. □