Kazakhstan Enacts PSA Law: Summary Analysis of Its Terms

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Kazakhstan's long-awaited PSA Law (the "Law of the Republic of Kazakhstan on Agreements (Contracts) on Production Sharing for Petroleum Operations on the Sea" – referred to below as the "PSA Law" or simply the "Law"), was signed by President Nazarbayev on July 8 and officially published on July 15, 2005.[1]

This Law is Kazakhstan's first dedicated exclusively to production sharing agreements, although some PSAs have already been signed and are in operation (*e.g.,* Karachaganak and Kashagan in the 1990s, Tyub-Karagan in 2003, and Kurmangazy, just signed on July 6, 2005) on the basis of general references in the Petroleum Law, Subsoil Law, the Tax Code and various RK Government acts (*e.g.,* Government Decree No. 708 of 2002).[2]

The Law introduces several new and important requirements and other features for new PSAs, which will distinguish them – in substance, in administration and in negotiation/signature process – both from non-PSA subsoil use contracts (so-called "tax/royalty" or "concession" agreements) and from previously signed PSAs. It should be noted that (per art. 33.1 of the Law) the pre-existing PSAs, considered to be "grandfathered", will not be affected by the new PSA Law. The full reach of this "grandfathering" requires careful analysis of each individual case, taking into account the relevant provisions of the particular PSA and any special implementing decrees, specifically the Petroleum Law, the Subsoil Law and the Tax Code. In any event, provisions of the new Law that do not conflict with the provisions of an existing PSA might be argued to apply to it; however, this will be a matter of interpretation and debate.

As indicated above, the new PSA Law is not intended to "stand on its own." As expressly stated in arts. 2.1 and 2.2, and as a matter of general interpretative principle, this Law is a "special law" which builds on (and prevails over, in the case of conflict) other directly relevant laws like those previously mentioned, the Petroleum Law, the Subsoil Law and the Tax Code – as well as Kazakhstan's general legislature. On the other hand, per Law art. 2.3 and Kazakhstan's basic constitutional principles, provisions of treaties in effect for Kazakhstan prevail over any inconsistent Law provisions that may exist. (This rule may afford a measure of extra protection in some cases in the area of stabilization, etc. See related discussion at Section 12 below.)

For further general background and context on Kazakhstan's contract-based hydrocarbon resource development regime, the hybrid civil/administrative law nature of PSAs (and of the other recognized subsoil-use contract forms – concession and service), and a detailed discussion of the most recent important amendments of December 2004 to the Petroleum Law, the Subsoil Law and the Tax Code (many of whose terms still remain applicable to PSAs in the absence of special provisions in the new PSA Law), see our February 12, 2005 memorandum entitled "Kazakhstan Amends Its Subsoil Resource Development Regime: Related Changes Still to Come" (also published in the March 2005 issue of *International Energy Law and Taxation Review*), and the "February 2005 Bulletin" (and in particular its Section I.B.11 on contract types). We can provide a copy of this to anyone who needs it.

Final preliminary note: Those familiar with Russia's PSA Law (now barely in use) will find several familiar provisions in Kazakhstan's new Law. Indeed, this "Russian inspiration" is expressly recognized in authoritative notes prepared by the RK Government and by the drafting commission.

The following is a summary presentation of the PSA Law's key terms, beyond the few noted above. Our aim is to high-

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[1] So far we have only the official Russian language text, which we can provide to anyone needing it. A good English language translation will no doubt be generally available before long.

[2] Reference is made, here and throughout this memo, to these key laws in the area: Law on Petroleum of June 28, 1995, No. 2350, most recently amended effective January 1, 2005 – the "Petroleum Law" or "PL"; the Law on the Subsoil and Subsoil Use of January 27, 1996, No. 2828, most recently amended effective January 1, 2005 – the "Subsoil Law" or "SL"; and the Code on Taxes and Other Mandatory Payments to the Budget (Tax Code), most recently amended effective April 15, 2005 – the "Tax Code".

light points that are clearly new or changed from the pre-existing regime, which we try to put in the context of the broader picture related to the PSA Law. We do not try to provide a complete description of all the provisions of the Law, or full interpretation of all unclear points (of which there are several).

For Marine Projects Only

! The Law's title, preamble, and article 1 make clear that it applies only to projects in Kazakhstan's sector of the Caspian Sea (of which there are already several projects and plans for several more) and the Aral Sea (though there are none yet nor any envisioned in the near future).[3]

! The PSA form could still theoretically remain available as well for future field projects on land – on the basis of general Subsoil Law, Petroleum Law and Tax Code references (although some early authoritative commentary may be read as suggesting otherwise). In any event, it seems the Government may not be interested in signing any new PSAs for onshore fields in the foreseeable future. Likewise, a standard concession agreement form seems unlikely to be approved for new marine projects, even if an investor were to specifically desire such a concession.

Terminology (e.g., "Petroleum"; Oil, Gas)

! Unlike the Petroleum Law and the Subsoil Law, the new PSA Law does not have its own set of defined terms. However, it uses several terms (albeit in lower case) that are defined in one of the other pre-existing laws. For example, "*neft*", which is no doubt intended to be translated broadly as "petroleum", encompassing crude oil as well as condensate, natural gas, etc. per the Petroleum Law definition; and "*neftyaniye operatsii*", accordingly, "petroleum operations".

! Note that the Law contains no special provisions aimed uniquely at development of gas fields. (See PL art. 30-4 regarding possible gas field retention and PL art. 30-5 regarding gas.)

Methods for Obtaining Blocks; Mandatory KMG Share; Strategic Partner

! Apparent primary method (art. 3.1): RK Government designates blocks to be offered at tender, which may be open or closed.[4] (There is no requirement of an earlier unsuccessful tender of a field on tax/royalty terms, as was present in an early draft of the Law and is the case in Russia.)

! If provided for by treaty, or to fulfill "other obligations" of the Republic, the Government may designate blocks for PSA development without tender. This was the case with the PSA of the large Kurmangazy field that straddles the Kazakh/Russian Caspian boundary, for example, signed in early July 2005 between KMG and Russia's Rosneft. Going forward there may be more cases such as this one.

! Furthermore, per PSA Law art. 3.1, the general PL-based provision for the "national company" (i.e. KazMunayGas (KMG)) to obtain field rights by "direct negotiation", another basic exemption to the tender-only rule, applies to marine blocks for PSA development as well.

! While the PSA Law itself does not mention "strategic partners", this new concept, recently introduced into the Petroleum Law in December 2004, is surely meant to apply to offshore PSA block development under the new Law as well. Per the PL art. 1(32) definition, a "strategic partner" is a local or foreign company (or consortium thereof) chosen by KMG in agreement with MEMR (the Ministry of Energy and Mineral Resources) for participation in development of a field without tender, by KMG/MEMR direct negotiations or in accordance with a treaty.[5]

! KMG as national company is given (per the new Law art. 5.1(2)) "the right of share participation as contractor [i.e., investor] in the amount of not less than fifty percent in all PSAs concluded by the republic." This appears to encompass all PSA-form field projects whether pursued without tender (by direct negotiation or per treaty) or by tender (consistent with the relevant SL and PL provisions from December 2004). There is a question whether the quoted language absolutely requires KMG to have a 50% interest in each PSA at the outset, or is meant (literally) to provide only this "right", which may or may not be exercised. There is room for argument based on other provisions of the Law, and authoritative interpretation and practice will develop in time. (See also footnote 4 of our February 2005 Bulletin for some pre-Law background in this area.)

[3] Indeed, the Law may be said to have had its impetus from the State Program for Development of the Caspian Sea to 2015, enacted by Presidential Edict No. 1095 of May 16, 2003.

[4] The first set of Caspian blocks for tender has been expected for the past year. It presumably will be announced by decree soon, now that the PSA Law is enacted.

[5] This provides a clear legal basis for KMG to invite large, financially capable foreign oil companies to take up a portion (say, half) of KMG's share interest in such field development (per KMG's direct negotiation right and/or per treaty), with the foreign company now having the comfort that its participation-without-tender position is legally secure. This is precisely what appears intended for development of the offshore Kurmangazy field (with Total continuing to be mentioned in press reports as KMG's most likely strategic partner), and may be intended for some more Caspian fields as well.
PL art. 7-1 also provides that such a strategic partner company must pay (i) the full signature bonus and (ii) full costs of exploration (*i.e.*, must carry KMG during exploration), unless the JOA is negotiated to provide otherwise.

In any event, KMG surely has the right to sell/assign a portion or perhaps even all of its 50% to one or more strategic partner(s) in appropriate cases – see, e.g., Law art. 11.2.

! Thus, under the general SL/PL regime, oil company investors may participate in a PSA as contractor either through tender for the right to participate with KMG (the latter holding its pre-determined mandatory share) or as strategic partner in direct negotiation or other non-tender cases as determined by the Government/ MEMR.

Parties to PSA: Further Points

! The basic parties (per art. 5.1) are **(i)** the Republic of Kazakhstan (on behalf of which the Competent Body – now MEMR – acts/signs) and **(ii)** one or more "contractor" parties (local and/or foreign companies).

! According to art. 5.2, the role of contractor may be played by "a few legal entities, which created a group (consortium) without a status of legal entity in accordance with [Kazakh law]." It could be interpreted from this language that the consortium itself shall establish and register a simple partnership (joint activity agreement) per the RK Civil Code Chapter 12. The Art. 233 of that Chapter recognizes "consortium agreement" as a form for simple partnerships. However such a reading is too rigid. Foreign-law-governed standards for Joint Operating Agreements (JOA's) should be allowed.

! In any event, the consortium members bear joint responsibility before the Republic for performance of PSA obligations, although they are permitted to provide special intra-consortium liability rules in the JOA.

State Agency Competencies

! *RK Government* (art. 7): By basic analogy/extension of the general SL/PL regime and above provisions, the Government (acting for the Republic) is to confirm lists of blocks for PSA development and likewise the type of tender (open, closed); confirm fields for development without tender (on basis of treaty or otherwise); confirm KMG's mandatory share in tendered and non-tendered (direct negotiation) fields; determine basic PSA parameters (and confirm a model PSA); determine basic tender terms; form tender commissions and confirm tender rules; confirm procedures for the Authorized Body's protection of state interests in PSAs and determine the Authorized Body for each PSA (see below).

! *Competent Body* (art. 8) – now MEMR: Again, by analogy/extension of the general regime, MEMR is to prepare and run tenders, prepare and introduce to the Government lists of fields for PSA tenders and basic PSA parameters, and confirm feasibility studies for PSAs; develop (with KMG and other relevant state agencies) and introduce to the Government tender terms; determine fields to be assigned to KMG by direct negotiation, and approve the KMG-proposed strategic partner for a field project; sign PSAs on behalf of the Republic (per art. 5); and perform "state control" of PSA performance (per art. 28).

! *Authorized Body* (art. 11) – special institution for PSAs (but again by extension from existing basic provisions in the SL, PL (especially art. 7-1) and decrees concerning KMG's intended quasi-administrative role, under MEMR, in all subsoil resource development projects):

– Appointed (by the Government) for PSAs in which the contractor comprises more than one company (*i.e.*, that has at least one party in addition to KMG), but *not* for those where KMG's share is 50% or more and the project operator is KMG's subsidiary (essentially now meaning KMG's marine project subsidiary KazMunayTeniz (KMT)).[6] However, an Authorized Body would be appointed if KMG later assigns part of that share to another company.

– The Authorized Body can/will be KMG itself if KMG's PSA share participation has been transferred to its subsidiary (KMT) or sold to another company; otherwise it will be another state agency or legal entity designated by the Government. The basic anti-conflict principle here is that a contractor party, including KMG, may not simultaneously act as Authorized Body for a PSA. (But query the extent to which this conflict actually is resolved in cases where KMT is the state participant in the contractor and KMG is the Authorized Body.)

– Authorized Body functions (which are "a mandatory part of a PSA"): representation of state interests in PSAs as determined by the Government; monitoring and control of contractor's PSA activities (with the exception of state – MEMR, etc. – control functions); receiving and handling the Republic's PSA share of production; auditing and reporting on contractor's claimed project costs for recovery; participation in the project Management Committee; participation in receiving PSA-related assets being assigned to the Republic upon cost recovery or project termination; and other matters of state interest relating to PSA implementation and termination.

[6] KMT was established by KMG in 2003 for the purpose of developing Kazakhstan's marine (Caspian and Aral Sea) hydrocarbon projects, including the border projects under international treaties.

PSA Tenders, Terms

! Conducted by tender commission established by the Government, under "uniform quantitative criteria" developed and submitted by MEMR on the basis of the feasibility study for each field and confirmed by the Government, and tender rules developed by MEMR with KMG input. See arts. 12, 13.1 and .2. The KMG role in this is further based on the national company's general authority, per PL art. 7-1(3), to participate "in the organization of tenders."

! The following must be set out as basic tender terms (arts. 13.3 and .4 – reflecting similar recently added SL provisions): Kazakhstan content requirements; mandatory supply of extracted petroleum for refining/processing in Kazakhstan;[7] and obligations to develop high technology and infrastructure in Kazakhstan – with this later being "the determining criterion in the choice of a tender winner", and per the following established order of priority of consideration:

– first priority: introduction of high-technology in the following sub-priority order: petrochemical and further processing production, or production otherwise related/ joined to the basic E&P activities; production relating to services supplied to the contractor;

– second priority: new processing production, trunk and other pipelines; and

– third priority: construction and joint use of other infrastructure (presumably meaning ports, rail terminals, etc.).

! See also the related statement (at Law art. 27) of specific "economic interests of the state" (items similar to the above-summarized tender terms, plus some others) "to be achieved in the process of applying PSAs."

! See our February 2005 Bulletin (Sections I.B.3 and 4) for detail regarding further tender criteria and procedures under the recently revised SL/PL rules, which are likely intended to be applicable to PSA tenders as well in the absence of any contrary or overriding PSA Law (or individual tender announcement) provisions on point. Namely the following:

– Kazakhstan content requirements (for contractors' purchases of goods, work and services, as well as with regard to their own labor force), per existing Government decree rules and as tightened by recently added provisions in the SL itself.

– SL-based tender requirements in the area of exploration obligations, size of various bonus and other payments/contributions; compliance with environmental (including abandonment) and safety rules; and financing of operations.

– Basic tender procedures not addressed in the Law, including: (i) minimum one-month period between tender announcement and application deadline, and minimum three months between announcement and actual tender; and (ii) in the event a tender attracts only one proposal, the commission is to send out a new notice. If there are still no more proposals the tender will be valid with only the one existing proposal.

! If there are three or more bids in a tender, a two-stage procedure will follow, which will result in the short-listing of at least two participants. (The short-list will be determined per the bids that are the most advantageous to Kazakhstan in accordance with the Law art. 13 criteria). The tender commission can then request supplemental "improved" submissions from the short-listed participants, and the winner is selected. (Law arts. 12.3, 14.1)

Negotiation and Signature; Supplemental Agreement

! After determination/announcement of the winner, PSA negotiation/signing procedure will proceed as follows:

– A working group will be formed within a month to negotiate the agreement, whose terms must include all of the approved uniform quantitative criteria (or improvements thereon) and other committed obligations per Law art. 13, and otherwise must not contradict the tender terms (art. 14.2).

– A "protocol" is to be signed after every stage of the negotiations (art. 14.5). These protocols, while perhaps not binding from a strict legal point of view, may serve a useful purpose of "nailing down" essentially agreed upon points along the way – and their provisions may be hard to back away from later as a practical matter.

– The PSA must be signed within a year of establishment of the working group (art. 15.1). If this fails to happen, the tender result decision can be revoked and a new agreement can be negotiated/signed with the second-place finisher at the tender (Law art. 14.6, SL art. 41-7.9).

! In addition, the Art. 13 stipulates that a governmental agency and the tender winner shall ne-

[7] Such obligation of E&P contractors to supply product for local refining/processing has routinely appeared in concession agreements to date, apparently based on general provisions in the Petroleum Products Turnover Law of 2003 and the Petroleum Law contemplating such required supply. Now it is expressly stated in the new Law as a mandatory tender term obligation for PSA contractors. The actual significance of this obligation may not be so great in practice, as production from new projects grows more rapidly than Kazakhstan's domestic refinery capacity and consumption needs.
See also the related Petroleum Law art. 35 priority right of the Republic to purchase petroleum from the shares of foreign and private domestic E&P project contractors at world market prices, and the further PL art. 36 right of the Republic to requisition petroleum from all project contractors – proportionally – in the event of national emergency (with particular provisions on compensation). These points should be assumed as generally applicable to PSAs as well, perhaps subject to investor protections as may be negotiated and built into the agreement.

gotiate and sign a "supplementary agreement" with regard to high technology, product processing, pipeline and other infrastructure obligations taken on, to the extent these obligations are not properly placed under the umbrella of petroleum operations. Otherwise such obligations are presumably to be reflected in the PSA itself (See art. 15.2). Such obligations are to be performed starting from commercial discovery.

! *Important note*: SL art. 63-3, which in December 2004 first introduced the concept of "supplemental agreement" for these special obligations, states: "Expenses of the subsoil resource user associated with fulfillment of these obligations, are not subject to recovery from extracted petroleum under a production sharing agreement." We suppose that this seemingly harsh statement, read together with the new PSA Law art. 15.2, is meant to apply only to costs related to fulfillment of such obligations that are outside the appropriate bounds of petroleum operations under the PSA itself (arguably such as for construction of a new trunk pipeline, processing plant, or port far beyond the contract territory bounds). This must be clarified in a way that is economically sensible and legally secure for investors; otherwise much-needed export infrastructure may not so readily be built).

! The Government may at some point issue a model PSA, although its precise role seems uncertain. We note the deletion from an earlier draft of the Law of a provision for all PSAs to adhere to the model PSA terms (currently a model PSA does not exist). See also footnote 13 of our February 2005 Bulletin, regarding an existing model subsoil use contract – not fit for the PSA form.

Development Period; Renewal; Conversion

! It appears that PSAs can only be applied to combined exploration and production (E&P) or just production projects (Law arts. 1.2, 3.1, 6.2), as opposed to "strictly exploration" concession contracts, where the successful contractor has priority right to be granted the production contract upon commercial discovery. (On the other hand, note the PSA Law art. 33.2 provision that contractors having exploration-only contracts predating this PSA Law have an option of converting to a PSA upon commercial discovery, with observance of the SL art. 64-1 procedures. This right presumably applies only to marine fields.)

! Per Law art. 6.2, the term of a PSA may be up to 35 years for E&P and up to 25 years for production only, but up to 45 years for "unique" deposits (not defined in the Law, but perhaps determined by reference to PL art. 26.2 – over 100 million tons of oil and/or 100 million cu.m. of gas); and with this 45-year period presumably (although the wording is not crystal clear) applying to production only, so that the total allowable E&P term for such fields could be up to 55 years. This compares to the same basic maximum 35 years for E&P or 25 years for production only, or 40 years for production on large deposits (which would mean a possible 50 years overall for E&P), per PL art. 26.[8]

! The Law does not provide for extension of the contract period as such, as typical for concession contracts (per SL art. 43 and PL art. 26). Instead, art. 6.3 of the Law provides that the right to produce under a PSA can be prolonged for the time sufficient to completion of economically justifiable production by means of signing a new PSA. However, this new contract for the additional period will no longer be "stabilized" back to the initial contract and law terms, rather, per art. 6.2, it will be governed by the terms of the law (PSA Law, Tax Code, etc.) in force at the time of the "extension".

Operations; Transport Facilities

! Typical provision for Management Committee (art. 17), with equal representation from contractor and Competent Body (including the Authorized Body represented on the latter side).

! Either the contractor itself or a specifically designated operator (Kazakhstan or foreign entity, including possibly a member of a contractor group) may perform the operator functions, per art. 18. (But note the statement in art. 27(5) that "attracting Kazakhstan organizations as operator" is one of the "state economic interests" to be pursued.) Financing and other terms of the operators are to be determined in the JOA.

! Apparent application of all environmental rules under the SL (Chapter 6), PL (Chapter 9) and general law, including the special stiff rules for marine petroleum operations (PL Chapter 6-I).

! Contractor's right of access to and use of the trunk pipeline system (and other means of product transport, storage and processing) "without any discriminatory terms." Also, contractor's right to construct its own storage, processing and transport facilities (art. 20). However, one must consider the interaction of these bare provisions with other relevant legal acts, including the natural monopoly rules, regarding the real scope of an upstream project investor's control rights in a "proprietary" trunk pipeline.

[8] An official Kazakhstan state press agency report states that the new Kurmangazy PSA, signed just before the PSA Law comes into effect, has a full E&P term of 55 years. (We understand that this is divided into exploration and appraisal: 5 years + 10 years of possible extensions, and production: 40 years.)

Taxation; Banking and Currency

! Production sharing, cost recovery, general taxation terms, and tax stabilization (tax regime as of PSA signature date governs) are all carried out in accordance with the applicable provisions (at Chapter 10, Subsoil Users) of the Tax Code as confirmed at Law art. 21. (See Section 12 below re general PSA stability.)

! Part II of our February 2005 Bulletin is a full summary of the current tax regime for the so-called "Model 2" PSA form as well as the "Model 1" tax/royalty (concession) form, in effect as amended since January 1, 2005. Several new Tax Code amendments affecting subsoil use (specifically PSA) taxation among other matters, are currently making their way through the Parliament and could be enacted by September or shortly there after. The changes are due to include slight improvements for investors **(i)** on the R-Factor, IRR-Factor and P-Factor alternative trigger formulas for calculating profit-production split; and **(ii)** on the minimum required state take, or so-called "top-up tax".

! Note that there is no "direct sharing" PSA variant (i.e., replacement of all taxes by simple agreed overall production share) permitted under the Law and the Tax Code as there is in Russia.

! Dedicated foreign bank accounts are expressly authorized. Otherwise, it is stated that currency operations are to be carried out per general Kazakhstan currency law (in other words, no special benefits or exemptions given) – see Law art. 23. This may be a continuing area of concern for investors.

Assignment of Rights/Obligations; State Preemptive Right; Pledge

! *General transfers* (art. 24.1): A contractor may do a full or partial transfer of its PSA rights/obligations "in the manner provided by [Kazakh law]", and on condition that the proposed transferee has the necessary financial, technical and management capabilities. The above quote is a reference to the general PL art. 53 and SL art. 14 requirements and procedures for Competent Body (MEMR) approval of any such transfers, including the special permissive SL art. 14.9-1 rule for transfers to affiliates. Thus, for PSAs there will also be important uncertainties regarding the intended scope of the approval requirement to cover transfers beyond direct ones of the subsoil rights themselves (*i.e.*, transfer of shares in a company that holds the rights – including at the second-tier and/or offshore level). (See Section I.B.2 (second bullet point) of our February 2005 Bulletin for a summary of the situation in this area).[9] Furthermore:

– In the case of full transfer, all the obligations under the "supplemental agreement" must be transferred as well.

- In the case of a partial transfer, there must be a JOA that reflects the scope of the rights/obligations transfers under the PSA and the supplemental agreement.

! *State preemptive right*: The PSA Law itself says nothing about the application of Kazakhstan's recently-enacted (as of December 2004 – SL art. 71) priority right of the Republic to buy into any subsoil E&P project upon an existing contractor-participant's announced intention to sell its share. However, this state right presumably will be claimed to apply in the PSA context per the above-noted Law art. 24.1 provision on transfers. (See our February 2005 Bulletin at Section I.B.2 (first bullet point) for summary discussion).

! *Pledge of rights* (art. 24.3): permitted, upon MEMR approval, to secure financial obligations undertaken "in connection with performance of the PSA" and "in accordance with [Kazakh civil law]." This is in line with the newly-revised general SL art. 14 rules. (See February 2005 Bulletin at Section I.B.2 (third bullet point)).

Stability and Related Guarantees

This is and will remain a particularly important, intricate and somewhat murky area, in regard to newly-concluded as well as pre-existing PSAs – per the provisions of Law arts. 25, 26 and 33.1 as well as other applicable laws (the SL, the PL, the Civil Code, the Investment Law of 2003 and its predecessors) and bilateral and multilateral investment-protection treaties. (See February 2005 Bulletin Section I.B.10 (and the further sources cited there) for more detailed analysis.) Also, keep in mind the required special analysis of tax stabilization as noted above, per PSA Law art. 21.2 and the Tax Code.

Notable specific points with regard to the PSA Law arts. 25 and 26 stability/guarantee provisions (which, unfortunately, are modeled closely after an analogous hodge-podge of guarantees and carve-out provisions stated in Russia's PSA Law) as follows:

! General principle (art. 25.1): PSA provisions remain in effect for the entire term. Amend-

[9] In this connection, we note a recent public statement by Kazakhstan's MEMR Minister Shkolnik, reported in the official state press outlet *Kazakhstan Today* on June 30, 2005, that any possible sale of subsoil rights or shares relating to PetroKazakhstan (which sale has been widely rumored of late – and which, if it were to occur, might involve a second-tier and/or offshore company sale) would be subject to the state's approval and preemptive rights under law. (PetroKazakhstan presents a non-PSA context.)

ments may be introduced only by agreement of the parties.

! Per art. 25.2: If during the PSA term there are any legislative changes "that worsen or improve the commercial results of the contractor's activity" under the PSA:

– Amendments "shall be introduced" to give the contractor the commercial results it could have received under the legislation in effect at the time of PSA signing. (The procedure for introducing such amendments may be agreed and set out in the PSA. We suppose this could include express time limits, and provision for arbitration in case of failure to agree.)

– However, there is no provision for stabilization by indemnity in case full compensatory amendments cannot be agreed. Potential investors may try to achieve this in PSA negotiation, but to our knowledge no investors have achieved it in any project agreement in Kazakhstan to date.

– Carve-out from stabilization in case of changes in law regarding environmental protection or safety.

– Compare this to generally applicable SL art. 71 and PL art. 57, and their provisions that state that changes in law that "worsen the position of the contractor" do not apply, and with carve-out for law changes regarding "defense preparedness, national security, ecological security and health."

! Per art. 25.3, a further "guarantee of stability" of PSA terms, but which are again subject to certain carve-outs for changes in law regarding **(i)** the procedure and conditions of import, production, sale of excisable goods (which includes crude oil and condensate per Tax Code art. 257.1(10)), and **(ii)** "national or ecological security, health or morals." This provision mirrors a similar carve-out from stability contained in the Investment Law of 2003 art. 4.3.

! Further "guarantees of contractor's rights" and carve-outs, per art. 26:

– Contractor is guaranteed "protection of property and other rights obtained and being effectuated by it in accordance with the PSA."

– Contractor is protected from any acts by the executive branch (presumably meaning at national and regional level) and any local government acts that would restrict rights under the PSA, with carve-out for lawful acts in the areas of environment, safety, health, and social and national security.

! Note these additional effective "carve-outs" from stability: by conceivable application of certain special Civil Code rules that arguably allow termination initiated by one party (see Section 13 below), and in the event of PSA development period renewal beyond the original term (see Section 8 above).

! As noted above, Law art. 33.1 states simply and usefully: "[PSAs] concluded by the Republic of Kazakhstan prior to entry into force of this Law shall preserve their force."

Termination Risk

! General principle (art. 30.1): a PSA may be terminated on the basis and per the procedures set out in Kazakhstan law in effect as of the day the agreement is signed, or in the agreement itself. (See art. 4.2 which has a similar effect (i.e. possible restriction, suspension, termination of PSA subsoil use rights). This could have two meanings: (i) that the general provisions for termination (as well as suspension and restriction) of the rights containing in SL, PL (its art. 27 refers to the SL) and Civil Code are applicable to PSAs; and (ii) that provisions of a particular PSA may supplement the Kazakh law; however PSA provision that contradicts such termination, suspension, and restriction provisions of Kazakh law would not be fully enforceable. Not sure what is trying to be said here. Please clarify. Further specific points as follows:

– See SL arts. 44.7 (penalties for non-fulfillment of contract obligations, including required Kazakhstan content), 45 and 45-1 (recognition of contract void; suspension of petroleum operations in various circumstances); and 45-2 (amendment and termination of contract).

– SL art. 45-2 provides for unilateral termination by the Competent Body in the event of: (i) contractor's refusal to correct the grounds that led to a suspension, or failure to correct them in good time; (ii) failure to fulfill contract terms (including work program) after warning to do so; (iii) impossibility of correcting certain grounds for suspension (*i.e.*, these involving danger or threat to human life or the environment); (iv) material violation of contract obligations or work program; or (v) bankruptcy of the contractor, unless the subsoil rights are lawfully under pledge at the time.

– These SL provisions do not expressly contemplate the requirement of a court decision as prerequisite to termination, and indeed it may be argued to imply that such is not required. However, a strong argument can be made that, per general contract termination principles under Civil Code art. 401.2, a court decision should be required before PSA (or concession agreement) termination, at least on violation-type grounds. However, see also the related Civil Code discussion immediately below.

! Given the civil-law nature of PSAs (as other subsoil-use contracts) and specific relevant provisions of SL art. 42 and PL art. 25 (namely – "The manner of conclusion, performance and termination of a contract shall be carried out in accordance with this Law and [Kazakh] civil legislation"), one needs to keep in mind Civil Code grounds and procedures for contract termination as well. For example, in addition to the general Civil Code Chapter 24 (arts. 401-403), other provisions, such as contract termination provisions for material violation and similar problems as noted above, should be kept in mind as well:

– See Civil Code art. 404.2 regarding a party's opportunity to terminate on the ground of (i) impossibility to perform (art. 404.2(1) – also covered at art. 374), or (ii) amendment or rescission of a government act (art. 404.2(3) – also covered at art. 375), both of which grounds for termination apparently may (per authoritative commentary on the Code) be revocable unilaterally, without court decision. See also the related force majeure principle in Kazakhstan law (Civil Code art. 359.2: failure to perform contract obligation excused in the event of "impossibility as a result of force majeure"). Of course these possible bases of termination (or defense to liability for non-performance) must be analyzed and applied also in the light of the PSA Law and other applicable stability and related protections as summarized above.

– See also Civil Code arts. 157-162 regarding termination (nullity) of a contract declared (by interested party demand and court decision) to be invalid.

! Law art. 30.2 states this additional termination ground: A PSA, "the provisions of which on the means of taxation" per this Law have not entered into force within one year from the date of PSA signature, terminates automatically at the end of that year. This new provision, also borrowed from Russia's PSA Law, seems aimed simply to establish another deadline trigger, requiring the investor to start up actual PSA cost-recovery activities or have the agreement/rights taken away. There might have been a simpler way of phrasing this rule, but the intent seems clear enough.

! In light of the above discussion of possible PSA Law, SL, PL and Civil Code bases and procedures for termination, parties to PSAs (as well as concession agreements) are well advised to negotiate and implant in their agreement the maximum achievable protections – in terms both of grounds and procedures – against one-sided rights/contract termination by the state. Various applicable Civil Code provisions appear to support this avenue of supplementing statutory termination provisions by contract, and the PSA Law does not prohibit such.

Governing Law; Forum for Dispute Resolution

! There are two PSA Law provisions on governing law, both pointing to required application of Kazakhstan law, as follows:

– Art. 31.1 states: "The law of the Republic of Kazakhstan exclusively shall be applied to relations regarding conduct of combined exploration and production or production of petroleum on production sharing terms." This provision, which basically mirrors the general petroleum contracts rule of PL art. 53-1.1 might itself be read to require that the "governing law clause" of all new PSAs provide for application of Kazakh law.

– In any event this Kazakh-law-only view for PSAs is further supported by reference to PL 53-1.2: "There may not be established a provision on application of foreign law in contracts concluded with the Competent Body." Bottom line: there would be real doubt as to the legality/enforceability of an agreed PSA choice of another country's law even if ever now achievable in negotiation. (There could be an exception for border-area fields, per PL art. 53-1.3.).

– The similar PSA Law art. 1.2 provision seems aimed more at stressing the required application of Kazakh law to all PSA *operations* matters, including environmental, safety, labor, tax and the whole spectrum of other applicable laws.

! As to dispute resolution forum, PSA Law art. 31.3 refers to the applicable Petroleum Law provisions. That means PL art. 58, which itself provides as follows:

– Disputes between the contractor and the state (state bodies) regarding performance, amendment or termination of a contract are to be resolved by negotiation or in accordance with the dispute-resolution provisions agreed in the contract.

– If such a dispute cannot be resolved in accordance with the above (e.g., in the unlikely event that there is no contract dispute-resolution provision), the investor may turn to (i) Kazakhstan court, or (ii) international arbitration "in accordance with [Kazakhstan's] investment legislation."

– A complicating element here is that the current Investment Law (at art. 9), unlike the old Foreign Investment Law, does not specify acceptable international arbitration procedures. Instead, it merely endorses investment-related dispute resolution in accordance with Kazakh treaties and laws (or as agreed by contract). Relevant treaty provisions would include those found in Kazakhstan's bilateral investment treaties (e.g., Kazakhstan-UK BIT art. 8, providing for investor-state arbitration per ICSID, ICC or UNCITRAL Rules) and the Energy Charter Treaty (art. 26, providing for investor-state arbitration per ICSID, UNCITRAL, Stockholm Chamber of Commerce or other contract-agreed rules). Kazakhstan is a party to the ICSID Convention. □