

Current Upstream Tax Regime in Kazakhstan

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This article is to make a short review of how Kazakhstan has got to the upstream tax regime it has today, and offer some thoughts on where it may be heading in the future.

We are all familiar with the key issues that affect Kazakhstan's international competitiveness:

- ! Big geological opportunities;
- ! High cost environment – offshore and especially in the North Caspian;
- ! Export costs;
- ! Country issues.

The framework of the current upstream tax regime as it stands today dates from the start of 2004, with some modest relaxation in 2005 and further relaxation in 2006.

Types of Tax Regimes

Exploration and production of oil, gas, and mining for minerals are subject to one of two regimes in Kazakhstan. The Excess profit tax regime or the PSA (Product Sharing Agreement) regime.

In reality PSAs are rare so far, and are generally limited to major oil and gas opportunities. The great majority of contracts have been EPT contracts. However, recent legislative developments suggest that this may change. In particular, the new PSA law is specifically focused on oil and gas opportunities in the Caspian.

The same tax regime applies to both oil and gas exploration and production, and hard rock mining for coal, base metals and precious metals. However, the economics of the oil and the mining businesses are very different. While there has been a reduction in interest in oil and gas under this tax regime since 2004, there has been a renaissance in the mining sector.

The main taxes that apply under the two regimes are shown below:

EPT Contract	PSA
EPT	State share of profit oil
CIT	CIT
Royalty	N/A
Signature Bonus	Signature Bonus
Discovery Bonus	Discovery Bonus
Export Rent Tax	N/A
	Top Up Tax
VAT/Customs	VAT/Customs

Both regimes are "multi layered", and are complex by international standards. There are also a variety of other minor taxes.

Stability

Stability of contracts is a subject that has been much discussed in recent years. It is clear in the Tax Code that all pre 1 January 2004 contracts are stabilized. It is also clear that new EPT contracts are not stabilized. It can be deduced from the Tax Code that new PSAs are in fact stabilized, since the Tax Code requires that the tax regime that governs a PSA throughout its life should be determined by what is in the contract, and it is specified that the tax regime contained in the contract should agree with the law in force at the effective date of the contract, rather than the law in force when particular liabilities arise.

Carry of State Oil Company

The introduction of a compulsory 50% carry of the state oil company through the exploration stage of new contracts (July 2005) has also been much discussed. If a project is successful, this does not result in a major deterioration in the project economics. However, it means that an investor is putting twice as much capital

at risk for the size of the opportunity actually available to the investor. This will obviously significantly reduce the expected net present value of the opportunity, and will be a significant deterrent.

It is assumed that carries will take the form of a loan. The Tax Code has not been adapted to deal with the concept of a carry, and as things stand, there may be some unintended tax effects.

Key Features of a Kazakh PSA

Below are the key terms of a Kazakh PSA, which have not changed much from the 2004 model:

! Cost Oil Ceiling

- Pre payback 75%, post payback 50%;

! Profit Oil

- Investor gets the lowest share of 3 triggers IRR, R Factor and Price Factor;
- Minimum investor share 10%, maximum 70%;
- Top up tax – State is guaranteed 10% of gross revenue pre payback, and 40% post payback;

! State protected against “deterioration in conditions”.

The “top up” tax now requires that Kazakhstan receives a minimum share of 10% of gross project revenues pre payback, and 40% post payback. The state share is the sum of CIT and profit oil. In 2004, the minimum shares were 20% pre payback, and 60% post payback. As a result of the relaxation, this tax now has little effect.

It is also reasonable to ask what is actually negotiable in a Kazakh PSA, since traditionally the key strength of the PSA has been its flexibility. The short answer, today, is not much. All terms including cost recoverable expenditure are, at present, hard coded in the Tax Code. The Government has, however, made proposals to introduce some flexibility to negotiate cost oil ceiling and the maximum investor share of profit oil, within pre-set ranges, though the effect on economics, even if the maximum flexibility is taken, is modest.

Signature and commercial discovery bonuses depend on reserve estimates for a particular discovery.

Newly accepted changes to PSA taxation

There have not been many significant deals done under these terms. The Government has responded to ongoing concerns of investors by introducing some further relaxation in the terms, to create some flexibility for negotiation. The amendments to Tax Code that came in effect starting from 1 January 2006 state that actual ceiling to apply on the profit oil triggers would be negotiated and fixed in the PSA somewhere between the current maximum of 70%, and a new maximum of 90%. Also the maximum Government take under the “top up” tax, pre payback, is negotiable to be fixed between 5% and 10%. As we will see, these do give rise to a modest improvement.

Key Features of a Kazakh EPT Contract

Under an EPT Contract, practically nothing is negotiable. All terms are hard coded in the Tax Code and bonuses depend on reserves. There are three special taxes that apply only to EPT contracts, EPT itself, a conventional royalty of up to 6%, and the Export Rent Tax.

Export Rent Tax Calculation

Exports of petroleum, except for petroleum produced under PSAs and exported by the PSA owners are subject to the export rent tax. This does not apply to any pre 1 January 2004 contracts. This tax is really an additional royalty on gross income. Where it does apply, the rate rises as the market price of oil rises, and hits a peak of 33% if the market price exceeds USD 40.

The tax can be completely avoided by selling domestically. However, this makes virtually no difference to the economics, since this tax is deductible in calculating both EPT and corporate income tax, and so as it reduces, they increase.

EPT Tax Calculation

Prior to 1 January 2004, EPT was a conventional IRR based calculation. Now it is rather unusual and applies once gross accumulated income exceeds 120% of accumulated expenditure. This ratio operates as a sort of undiscounted R Factor. As the ratio rises above 120%, the tax rate rises, starting from 10% and peaking at a rate of 60% if the ratio exceeds 1.7.

The tax base to which this rate is applied is the income that is subject to corporate income tax, minus the corporate income tax on that income, and minus 20% of deductible expenditures. This cal-

ulation is, so far as the writer is aware, unique among petroleum producing countries.

Cases

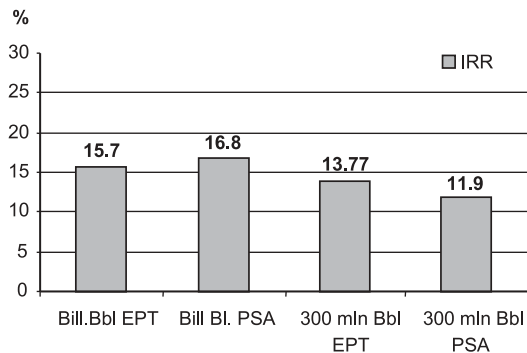
We have taken two reserve cases, one of a billion barrels recoverable, and another of 300 million barrels recoverable, and we have assumed two oil prices, USD 25 and USD 50.

Recoverable Reserves	1 billion barrels	300 million barrels
UTC (Unit Technical Costs)	USD 11.96	USD 11.54
Export (included in UTC)	USD 4.5	USD 4.5

The above table shows the reserves, the Unit Technical Costs, and the transport tariffs that we have assumed. These costs are the sort of costs you might encounter operating offshore in the Southern part of the Kazakh sector of the Caspian where it is ice free. To operate further north would add two to three dollars per barrel to the costs.

IRR at USD 50 oil price

The graph shows investors IRR's for our cases under the 2005 regime, assuming a USD 50 oil price:

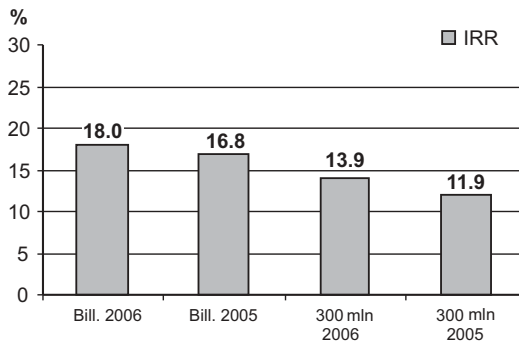


! The billion barrel EPT case gives an IRR of 15.7%, and the PSA case gives 16%.

! The 300 million barrel case gives an IRR of 13.77%, and the PSA case gives 11.9%.

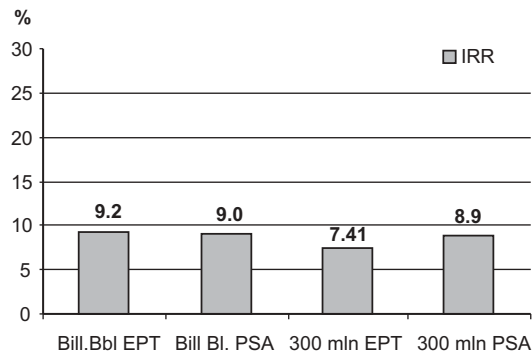
The PSA regime is very sensitive to the timing of expenditure, while the EPT regime is less so. A short intensive development period may have an IRR in a PSA of up to 2% less than a more relaxed phasing of the same total capital expenditure.

IRR at USD 50 oil price with 2006 changes



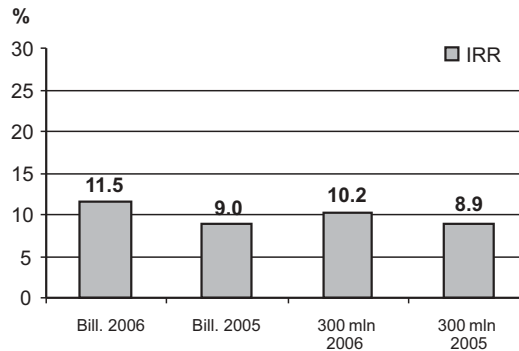
The above graph shows the PSA results comparing the current regime figures for the previous slide, with the results, assuming that the 2006 regime is applicable. The result is an improvement of around 2% for the small field, but only 1.2% for the larger field.

IRR at USD 25 oil price



This graph shows the IRRs using a USD 25 oil price under 2005 regime. All of the cases give a real IRR of less than 10%. The lowest IRR at 7.41% is given in the 300 million barrel EPT case, reflecting the fact that the trigger that determines the EPT rate is in effect an undiscounted R Factor.

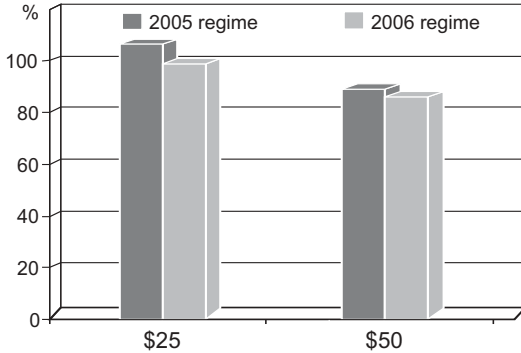
IRR at USD 25 oil price with 2006 changes



The graph shows the improvement in the PSA IRRs, assuming that the 2006 regime is applicable. Again, the improvements are in the range of 1% to 2%.

Division of Government Take

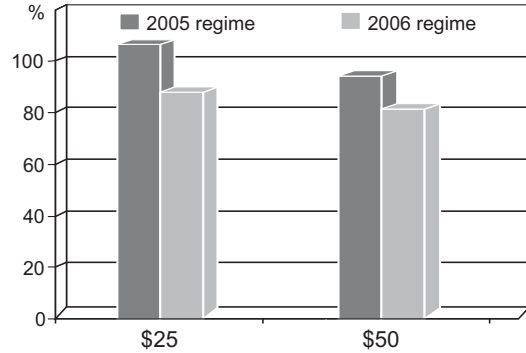
By Government take, we mean the State's share of the income that is left after project costs have been deducted from gross income. Around the world it ranges from 50% to around 80%, countries such as Norway being towards the top of that range.



This graph shows, for the billion barrel case, the modest reduction in Government take that will occur with the 2006 changes. At USD 25, the Go-

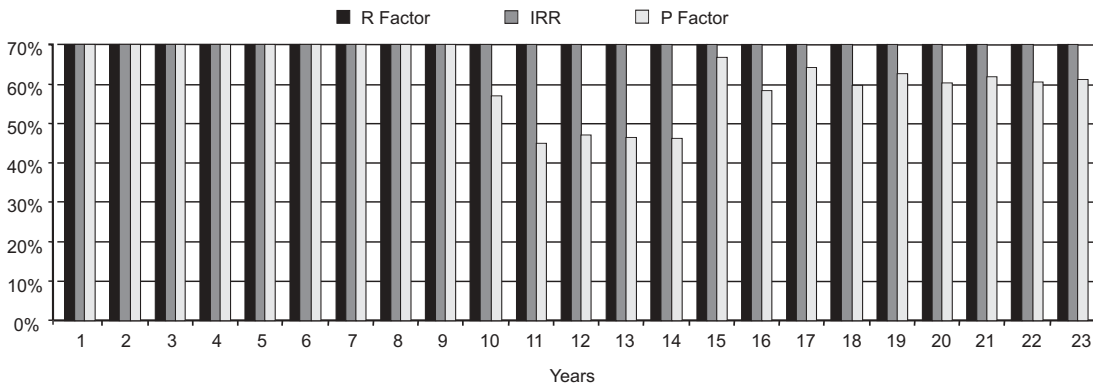
vernment take, using a 10% real discount rate is close to or exceeds 100% of the income of the project, so the state is protected at the expense of the investor. In the billion barrel case it is also high.

This slide shows the same information for the 300 million barrel case. In all scenarios, the Kazakh



Government take remains above 80%. Even allowing for the fact that these figures are discounted at 10% real, this is among the highest in the world.

Profit Oil Triggers



This graph shows the share of profit oil potentially allocated to the investor by each of the three triggers in the USD 25 billion barrel case. As can be seen, the IRR and R factor triggers would always allocate 70% to investors. The trigger that does the damage to the investor is the P Factor. The investor gets the lowest of the three potential shares. The P factor makes its maximum reduction in investor income between years 10 and 14, when the investor is receiving cost oil. This is because the P factor depends not only on the price of oil, but also, apparently, upon the share of total production that the investor receives. The higher the investor's share, the higher the P factor, and so the lower the share of profit oil that the investor gets. The P Factor is the single most important thing that would

need to be changed to improve the economics for the investor.

$$P \text{ Factor} = \frac{\text{Investor share of oil} (\text{cost oil} + \text{profit oil}) * \text{Price}}{\text{Total Project Production}}$$

This formula sets out a simplified version of the P Factor. If the P factor formula returns a value of less than USD 12 per barrel, the investor receives 70% of profit oil. If it exceeds USD 27, the investor gets only 10%. The income is to be discounted, and the price used in the formula is a netback price.

A constructive dialogue between investors and the authorities continues to develop a regime that meets the needs of all parties. □