Kazakhstan Further Tightens Subsoil Development Contract Controls: State Preemption; Assignment of Rights; Other Matters

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Kazakhstan has just introduced a set of important new amendments to its Subsoil Law ("SL"), Petroleum Law ("PL") and National Security Law ("NSL") – collectively, the "Amendments"[1]. The main thrust of the Amendments is to tighten state control over investors' (*i.e.*, hydrocarbon and other mineral resource E&P contract rights holders') direct/indirect sale or other assignment of contract rights. In addition, there are a few other clarifications regarding gas flaring, jurisdiction of various state agencies for resource use and environmental protection, and local work force salaries.

These Amendments, featuring tightened sale/assignment and preemption provisions, apparently were rushed through Parliament to presidential signature and enactment – as openly acknowledged by some state officials – for the Government to use as enhanced leverage in dealing with CNPC of China in connection with the then-pending $4.2 billion acquisition of Canadian-traded PetroKazakhstan (similar to the BG / Kashagan field sale-preemption situation that influenced the previous round of subsoil regime amendments in December 2004). According to press reports, the issues relating to the PetroKazakhstan acquisition have been resolved amicably by agreement between CNPC and KazMunayGas and blessed by the Government – reminiscent of the agreement of the Kashagan shareholders to admit KazMunayGas into that project earlier this year. However, the new Amendments are now in place for application to future proposed sales, and some real issues of interpretation remain.

We present here only a brief summary of the Amendment highlights. For fuller background on the general SL/PL and PSA regime, see our February 2005 bulletin entitled "Kazakhstan Amends Its Subsoil Resource Development Regime; Related Changes Still to Come", and our July 2005 bulletin entitled "Kazakhstan Enacts Its PSA Law: Summary Analysis of Its Terms."[2] The whole set of SL and PL rules for subsoil use contract/company sales or assignments and the state preemption right, as newly tightened by the Amendments, apply to PSAs (per PSA Law art. 24) as to other subsoil contracts. The intricate area of retroactive effect of the preemption/approval regime and possible "stabilization" protection for investors in various pre-existing PSA and other contracts is also covered in our February and July 2005 Bulletins, and will not be reviewed again here.

State Preemption Right; Sale/Assignment Approval

! *Subsoil Law article 71 paragraph 3, just introduced in December 2004, is now amended to read* (new language shown in italics):

"For preservation and strengthening of the resource-energy base of the economy of the country, in newly-being-signed and also previously signed subsoil use contracts *[irrelevant addition here]*, the state shall have the priority right before another party of the contract or the participants of a legal entity possessing the subsoil use right, or other persons, for the purchase of a subsoil use right (or its parts) and/or participation interest (shareholding) in a legal entity possessing the subsoil use right being

[1] The Amendments are introduced by the Law on Introduction of Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan Regarding Matters of Subsoil Use and the Conduct of Petroleum Operations in the Republic of Kazakhstan – signed by President Nazarbayev on October 14, 2005 and made effective as of the date of the official publication, October 18, 2005.

[2] The former bulletin (the "February 2005 Bulletin") was also published in the March 2005 issue of *International Energy Law and Taxation Review* (Sweet & Maxwell Publ.); the latter bulletin (the "July 2005 Bulletin") was also published in the July 2005 issue of the AIPN Advisor. We can provide copies of these upon request.

alienated, *as well as in a legal entity that has the possibility directly and/or indirectly to determine decisions and/or to exert influence on decisions taken by the subsoil user, if the main activity of such legal entity is connected to subsoil use in the Republic of Kazakhstan* – on terms not worse than those offered by other buyers."

! *Reach/interpretation of preemption right; consequences of violation:*

– The initially-enacted December 2004 language of the preemption right had left open for interpretation whether the right was meant to apply beyond direct transfers of contract rights and of first-tier Kazakh-incorporated subsoil user company shares. The amended language makes clear an extended reach to transfers of shares in second-tier companies (onshore or offshore) – as long as the stated two "control/influence" and "main activity connected to Kazakhstan" tests are met. Of course these new tests themselves leave open questions for interpretation in particular cases. However, Kazakhstan has clearly now served notice of intended application of its state preemptive right extraterritorially, to proposed sales of shares in typical offshore special-purpose companies (wherever incorporated) that directly or indirectly hold Kazakhstan subsoil contract rights.

– This amended provision makes no distinction between *privately-owned* or *publicly-traded* companies that directly or indirectly own or control Kazakh subsoil contract rights. Kazakhstan's purporting to restrict share sales of companies in the latter category (including companies traded on major international exchanges) may have particularly serious ramifications, and may well merit further discussion between the foreign investment community and the Government.

– A newly-added, related SL article 45-2(6) contract termination ground surely will help encourage investors to take a conservative view of the scope of the state preemption right as amended. That is, in the event of non-compliance (i.e. not giving the state the opportunity to make a pre-emptive purchase where such is deemed to have been required by SL article 71), the Competent Body (the Ministry of Energy and Mineral Resources – "MEMR") is empowered to terminate the underlying subsoil use contract unilaterally.

! *Procedure for exercise*. The Government issued a decree in July 2005 for administering exercise of the preemptive right.[3] It established an Interagency Commission, headed by representatives of MEMR, which meets to consider sale/assignment applications and makes recommendations to the Government as to exercise of the preemptive right. (The time period for this Commission's consideration/action on such applications is not stated; perhaps the general SL art. 14.1 45-day period is meant to govern – see below.)

! *National security basis; retroactive effect.* See our February 2005 Bulletin Sections I.B.2 and I.B.10 and July 2005 Bulletin Section 12. Note that the national security justification for the state preemptive right, already reflected to an extent in the existing SL article 71 wording, is now buttressed by Amendment changes to the National Security Law (article 18) itself – see further discussion of this aspect below.

Sale/Assignment Permission Regime Also Tightened

In addition to the SL article 71 state preemption right itself, the general SL article 14 and PL article 53 regime (all of which applies to petroleum contracts – see our February 2005 Bulletin at Section I.B.2 for a summary of this combined regime as it stood prior to the new Amendments) has been stiffened in various respects and must be taken into account, as follows:

! *SL article 14 provisions – applicable to all mineral resource contracts:*

– MEMR as Competent Body is empowered to deny permission not only on the basis of failure to demonstrate the would-be assignee's technical or financial capabilities or submission of false information, but now also if the proposed assignment of rights "would cause non-observance of the requirements of protecting the country's national security, including in the case of concentration of rights in the bounds of a contract and/or concentration of rights in the conduct of operations in the sphere of subsoil use" (new SL art. 14.9-1(3)).

– These two "concentration of rights" terms have been added as new SL definitions, in arts. 1(19-1) and (19-2) – apparently not related to terms already used in Kazakhstan's antimonopoly law or elsewhere. The first – concentration of rights in the bounds of a contract –

[3] RK Government Decree No. 789, July 29, 2005, "On the Creation of the Interagency Commission on Matters of Acquisition by the State of Subsoil Use Rights (or Part Thereof) and/or Participation Interests (Shareholdings) in a Legal Entity Possessing a Subsoil Use Right Being Alienated."

is defined as the size of an interest of one participant in a consortium having a subsoil use contract, allowing that participant "independently to take decisions regarding the subsoil user's activities" under the contract. The second – concentration of rights in the conduct of subsoil operations generally – is defined as the possession by one entity or a "group of persons" (a term taken from but not well defined in the anti-monopoly law and rules) from one country of such interest in subsoil use contracts in Kazakhstan or share capital of entities that are subsoil users in Kazakhstan "as to enable creation of or to create a threat to the economic interests of Kazakhstan." There clearly is much room for interpretation – and potential arbitrariness or mischief in application by the state – in these vague terms.

– See also the related Amendments provisions now introduced in NSL articles 18.3 and 18.6, evidently designed to buttress the state's case for the general importance, and possible retroactive application, of this newly-tightened permission requirement regime.

– The previous exemptions allowing free assignment to subsidiaries and by corporate succession (see SL arts 14.1 and 14.9-1), subject only to the requirement of a parent guarantee for assignment of rights to a subsidiary, have now been eliminated – so that the general regime of required permission applies there as well. (And note also the application to assignments in pledge.)

– MEMR's time period for acting on applications for permission has been lengthened from 15 to 45 days (SL art. 14.1).

! *PL article 53 provisions – applicable to petroleum use contracts:*

– As newly expanded and clarified in scope, PL article 53.1 requires MEMR permission for any transfer of interest in a subsoil use contract or of a shareholding in a subsoil-use rights-holding company.

– MEMR is empowered to refuse such permission "in the manner established by the Government", on bases provided in law (these "bases" likely referring to the grounds, existing and new, stated at SL art. 14 – see summary above).

– As with SL article 14, the previously stated exemption for assignments to subsidiaries ("to be agreed in the contract") has now been removed.

– In addition, there is a related new provision that the requirement applies "as well with regard to transactions with affiliated entities." This ties-in to a short new PL definition of "affiliated entity" (at PL art. 1(1)) that is quite different from the much more elaborate one contained in Kazakhstan's Stock Company Law. Problems of interpretation and application will no doubt arise in this area as well.

! *Reach, interpretation, procedures and practice, consequences of violation:*

– As may be seen from the above, the SL art. 14 and PL art. 53 permission requirements do not as clearly define their reach (*i.e.*, to proposed share sales/assignments in second-tier and/or offshore companies indirectly holding Kazakhstan subsoil-use contract rights) as does the newly amended SL art. 71 state preemptive right. Here again, there may be various interpretations of this distinction.

– Sales/assignments done in violation of the SL art. 14 (and perhaps also the PL art. 53.1) permission requirement are deemed invalid (void) from inception – per SL art. 14.5. There are also some other SL and PL provisions that might be applied by the state to threaten termination in the event of such violation – such as PL article 7-1(7) which may be read as providing an open-ended basis for unilateral termination of a "bad-faith contractor" and turning over its field to KazMunayGas (and the related property to the state). Thus, and for understandable reasons, investors would be wise to pay proper attention to these permission rules as well – even in cases where it is (or at least seems) clear that the Government is not interested in exercising the preemptive right *per se*.

– As stated in PL arts. 53.1 (noted above) and 5(12) (the Government is to establish rules for issuing permissions/refusals), a specific set of regulations is apparently anticipated. However, there do not appear to be any such rules (nor rules for applying the general SL article 14 permission regime) yet – as distinct from the above-noted July 2005 Decree No. 789 regarding the state's exercise of its SL article 71 preemptive right.

– Note further that by SL art. 71 the Government itself is empowered to exercise the preemptive right (acting with the aid of the Interagency Commission, itself administered by MEMR, as established by Decree No. 789), while it is MEMR (as Competent Body) that is empowered to

give/decline the required assignment permissions under SL art. 14 and PL art. 53. The conventional wisdom to date in this context is to send a single application to MEMR – as "working body" for the Interagency Commission regarding the state preemptive right and as Competent Body for granting SL and PL sale/assignment permissions – seeking a written response that ideally should reflect each of the required decisions/permissions. (Namely, the applicant should try to assure that MEMR's response is worded specifically enough as to cover the various legal requirements in a proper way – but in practice this may not be obtainable.) The wisdom and practice may well evolve further with experience and/or the issuance of additional detailed rules or guidance from the responsible authorities.

Gas Utilization/Flaring

- The relevant PL provision (article 30-5) was stiffened by the previous set of December 2004 amendments – so as to begin with a generally stated prohibition and then narrowed exemptions for permitted flaring (*i.e.*, to provide that beyond emergency cases of accidents and threats to health or the environment, flaring may be permitted for a project's well testing and pilot production phase for a period of time no longer than three years).
- The new Amendments have introduced another exemption, dictated by practical reality, for projects under subsoil use contract signed before December 1, 2004 and for the duration of their approved program for utilization of associated and/or free gas, if such program (i) was agreed/confirmed by the responsible state agencies before that date; or (ii) will be developed and agreed/confirmed by July 1, 2006 and has guidelines for permission to flare under various circumstances in the meantime.
- This is an area of heightened attention on the part of Kazakhstan's Ministry of Environmental Protection ("MEP") and Government representatives generally, and concern on the part of investors as the state's wish to maximize gas utilization presses more seriously against basic project economic/technical possibilities. There was quite a bit of discussion on this at and around the KIOGE conference in Almaty a month ago.
- There is an existing Instruction on Issuance of Permission for Gas Flaring, issued by the July 27, 2004 Order of the Chairman of the Committee on Geology and Subsoil Protection within MEMR. Per that Instruction, a subsoil user must obtain a gas flaring permit, issued for a one-year period and extendable upon certain conditions. For this the subsoil user must develop a "program for complete utilization of gas", which must be approved by the Central Commission on Field Development within MEMR, and a positive state environmental expert review ("SEER") conclusion may also be needed. After obtaining the flaring permit the subsoil user must report monthly, with the provision that the Committee on Geology and Subsoil Protection has the right to withdraw the permit if the subsoil user is not fulfilling its program.

Other Matters

- *Agency jurisdiction better delineated*: Read together, the SL and PL have been adjusted by several Amendment provisions (in definitions and throughout the texts), to better define the respective roles of the "authorized agency for study and use of subsoil resources" (MEMR, through its Committee on Geology and Subsoil Use, currently serves in this role – as well as being the "Competent Body" under these laws), and the "authorized agency in the sphere of environmental protection" (which is the Ministry of Environmental Protection).
- *Heightened/tightened environmental focus and rules*: This ongoing trend, beyond the gas flaring issue alone, is also reflected in the Amendments at various places. Just one example is PL articles 36-2.3 and .4, now adjusted to clarify that all drilling and gas injection activities require, among other permissions, a positive SEER conclusion.
- *Local workforce salaries*: A new SL article 42.2-4 has been added as follows: "In concluding a [subsoil use] contract the parties shall agree on the level of salary to be paid by the subsoil user to Kazakhstani personnel who are hired to carry out work under the contract, which shall be indexed annually per the official refinancing rate of the National Bank of Kazakhstan." □