Comments

Kazakhstan's Amended Legal Regime for Natural Resource Development: A Critical Analysis of the Key Changes

YURI G. BASIN, OLGA I. CHENTSOVA AND JONATHAN H. HINES*

Kazakhstan has substantially amended its two basic laws that govern all aspects of hydrocarbon and other mineral exploration and development projects, effective September 1, 1999. The result is a more comprehensive, internally consistent regulatory framework than that previously in place – marked by several improvements but also some new burdens, questionable aspects, and remaining draftsmanship issues.

In Section I below we offer some general thoughts on the nature of the changes and the resulting present legal regime. In Section II we address the key specific changes and additions. This discussion will of necessity be selective, with citations to legal provisions that should be explored further by the reader as required on a particular issue. We do not here attempt to provide a primer on the overall framework of the regime. The principal changes highlighted include:

- elimination of subsoil-use licensing;
- provision for "National Companies", including Kazakhoil;
- transfer and pledge of subsoil-use rights;

---

* Professor Basin is Distinguished Research Scholar of the Republic of Kazakhstan, chaired the Civil Law Department at Kazakhstan State University for over twenty years, was recently awarded the "Kurmet" Presidential Medal for outstanding service toward the development of Kazakh law, and is senior partner/consultant with the Aequitas Law Firm in Almaty. Dr. Chentsova is managing partner of the Aequitas Law Firm. Mr. Hines is international counsel with Debevoise & Plimpton in New York and Moscow. Both Professor Basin and Dr. Chentsova have served on several Kazakhstan government-appointed drafting commissions in recent years, and Prof. Basin reviewed and commented for the Government on drafts of the amendments to law that are the subject of this article. The authors gratefully acknowledge the assistance of Angelika V. Tsareva, an associate with Aequitas, and Dmitri A. Tartakovsky, a legal assistant with Debevoise & Plimpton, in the preparation of this article. The views expressed herein are the authors' only, and may not be ascribed to any client served by the authors' law firms.

- granting of rights (tightening of the tender requirement);
- types of contracts (PSAs, Model Contract, etc.);
- more stringent preference rules for local goods and services;
- imposition of Kazakhstan law as governing law;
- expanded environmental protection requirements, particularly with regard to hydrocarbon development operations at sea; and
- new requirements and restrictions (mostly relating to hydrocarbon projects) regarding commercial discoveries, work programs, cost recovery, ownership of equipment, gas retention and flaring, joint operations, and easements.

The new act that has effected these changes is the Law on Introduction of Changes 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, adopted on August 11 and made effective as of the date of official publication, September 1, 1999 (the "Amending Law"). This law has introduced major amendments to

(1) the Law on the Subsoil and Subsoil Use (Edict of the President having the force of law, No. 2828, dated January 27, 1996 – as now amended, the "Subsoil Law"); and
(2) the Law on Petroleum (Edict of the President having the force of law, No. 2350, dated June 28, 1995 – as now amended, the "Petroleum Law").[1]

The Amending Law also attempts (without wholly succeeding) to clarify the status of pre-existing licenses – such as those covering such important projects as Tenghiz Chevroil, Karachaganak and the Caspian offshore consortium ("OKIOC"). See Section III below for a discussion of this important matter of stabilization, or "grandfathering".

Since enactment of the Amending Law there has been a good deal of speculation as to the meaning of various of the new provisions. There are indeed uncertainties; we will take the opportunity where possible to clarify the likely intent of the Subsoil Law and Petroleum Law as amended.

---

[1] The one exception from the general September 1, 1999 effectiveness date for the changes is that new Art. 55.3-1 of the Petroleum Law, regarding the types of insurance required to be carried by contractors conducting exploration and/or production of offshore deposits, comes into effect on January 1, 2000. (Amending Law Art. 2.2) Contractors are thus being given a bit more time to comply with the new insurance coverage requirements.

I. GENERAL EVALUATION

It appears that the main impetus for enacting the amendments was that the Subsoil Law and the Petroleum Law were outdated and failed to reflect relevant changes introduced by subsequent legal acts – including several decrees of the Republic of Kazakhstan ("RK") Government – over the past few years. In addition, experience showed that important matters in the sphere of subsoil use remained entirely or essentially unregulated – such as environmental protection and resource development at sea. Further, the two basic laws were insufficiently coordinated with one another; thus, an aim was to eliminate these contradictions and discrepancies. Finally and significantly, the RK Government aimed to incorporate suggestions from the foreign investment community to streamline the legal regime and thus enhance the country's attractiveness as a resource-project investment target.[2]

Several draft versions of the Amending Law were prepared within less than a year beginning in late 1998, differing from one to the next in both concept and specific content. In the process of this work, the principal draftsmen (from the RK State Agency on Investment) distributed the drafts for comment among other RK state agencies, a number of prominent foreign companies and investment groups, law firms and other consulting companies, and certain recognized legal scholars in Kazakhstan (including one of the co-authors of this article). As a result, considerable work was done within quite a short period of time, culminating in enactment of the Amending Law in August 1999.

We believe that the amendments deserve a mixed review. On the one hand, a number of conceptual changes have been made which simplify and otherwise improve the legal regime from investors' point of view (including rejection of the dual license-and-contract system and switchover to a contract-only system of subsoil use); various issues are now regulated with greater precision (and thus, one hopes, predictability); this precision is achieved in part by introduction of several new or improved definitions of terms; and the Subsoil and Petroleum Laws are now better coordinated. However, some of the additions seem unduly stringent (*e.g.*, local supplier

---

[2] There is no readily available official legislative history – at least, none that we have yet seen. Of some interest in this regard is an article by N. Damitov of the RK State Agency on Investment and A. Mukhamedzhanov that appeared in the Almaty weekly business newspaper PANORAMA, Nos. 20 and 21, May 1999, entitled *Agency on Investment Has Developed Draft Law That Contemplates Introduction of Contract-Permission System of Granting Resource-Use Rights*. That Agency was the initiator and lead drafter of the Amending Law.

preferences and governing law) and/or insufficiently thought out (*e.g.*, the respective roles of the National Company and the Competent Agency, and environmental protection provisions).

Further, the rush to enactment has left some remaining and new inconsistencies and drafting errors within and between the two key laws. These include the remarkable provision in Subsoil Law Art. 44.3, following the literal language of the Amending Law, that a resource-use contract must be registered "and enters into force from the date of its signature and enters into force from the date of its registration . . . ." See also the further discussion below (at Section II.1.) of the need for even better synchronization between the two laws.

All things considered, we anticipate efforts in Almaty and Astana toward further amendments before too long. In the meantime, the changes just enacted by the Amending Law can and probably will be reflected and elaborated in updated versions of the many existing governmental regulations that address specific aspects of the legal regime – and certain new regulations may be in order as well.

II. THE KEY AMENDMENTS

In our view, the most important changes effected by the Amending Law are the following:

A. Synchronization of the Subsoil and Petroleum Laws

As a preliminary matter, we note that the Subsoil Law was and remains the basic framework law governing development of underground resources in Kazakhstan. Within this framework the Petroleum Law is considered a "special law" – *i.e.*, one that fills out many specifics concerning development of a particular type of underground resource (crude oil, gas condensate, natural gas and other hydrocarbons).[3] The Subsoil Law and the Petroleum Law are to be applied together, in harmony, where possible. (New Art. 2.5-1 of the Petroleum Law now sensibly specifies that petroleum operations will be governed by the principles, terminology and definitions contained in the Subsoil Law – and there are several more

[3] Edict of the President having the force of law, On State Regulation of Relationships Connected With Precious Metals and Gemstones, No. 2372, July 20, 1995, was another such special law governing another category of subsoil resources, but it was rescinded in 1998. Various governmental decrees still operate, under the Subsoil Law, to regulate development of Kazakhstan's gold and other precious metals resources.

specific Petroleum Law references over to the Subsoil Law than was previously the case.) However, in the event of a contradiction, the terms of the special law prevail. *See* Subsoil Law Art. 4 and Petroleum Law Art. 2.

This approach is sound, and even further movement in this direction would be desirable. Ideally the Petroleum Law, as a special law, should cover only the specifics of petroleum operations and not have any overlap with or duplication of the Subsoil Law's general provisions concerning subsoil use. However, despite the tightening introduced by the Amending Law, there still is a considerable amount of duplication and/or related inconsistency. This gives rise to interpretive uncertainty on some points of substance (*e.g.*, transfer of rights, local supplier preferences, and governing law – see below).

B. Elimination of Subsoil-Use Licensing; Contract As Sole Basis of Rights

1. General

Perhaps the most fundamental change introduced by the Amending Law is the rejection of the license-and-contract system of granting subsoil rights, which had been in effect for some years. The basic relations between the government and subsoil users are now to be determined by subsoil-use contracts alone, without preliminary issuance of a license. Accordingly, all provisions concerning subsoil-use licensing have been excluded from both laws. In line with these changes, the RK State Agency on Investment will continue to fulfill its role as Competent Agency in conducting tenders and negotiating, preparing and signing resource-use contracts on behalf of Kazakhstan (Subsoil Law Art. 8; Petroleum Law Art. 6; RK Government Decree No. 474 of April 26, 1999) but drops its function as "Working Agency" for the Government in the issuance and administration of licenses. (Note that the Competent Agency might continue to deal with issues relating to pre-existing licenses, which have been grandfathered by the Amending Law – see Section III below.)

2. Related Permits Still Needed

Elimination of the primary licensing requirement does not affect the process of obtaining several types of ancillary permits, licences and other documentation that are needed to undertake resource development activities, in connection with the contract or once it is in place.

First, the territorial boundaries of the field that the subsoil user is given rights to explore and/or develop are to be recorded in a so-called

"geological allotment" (*geologicheskii otvod* – covering exploration) or "mining allotment" (*gornyi otvod* – covering extraction) that is issued for each contract user, as a ministerial matter, and attached as part of the contract. (Subsoil Law Arts. 1.2-1 and -2, 41.8)

Then, on the basis of the resource-use contract and *otvod*, the contractor obtains land-use (*i.e.*, surface-use) rights from the relevant local authorities – in the form of a rental agreement or agreement on non-compensated use, depending on the category of contractor and other factors. (For this purpose the local authorities may, if necessary, take such land and/or rights from private owners or users, as provided for in land legislation.) *See* Subsoil Law Arts. 9.1 and 44.4-1, Petroleum Law Art. 7.1, and the so-called Land Code[4] Arts. 8.3, 12, 38.4, 122.6 and others.

There are also other licenses or permits that must be issued, once the contract is in place, to govern the various technical operations that the resource user will carry out (such as for surveying, drilling, construction activities, and discharges at sea).[5]

3. State Interference Still Possible

The ascendancy of the contract should streamline the processes for investors' obtaining and maintaining resource-use rights in Kazakhstan. However, this reform will *not* mean that investors' rights are entirely protected from unilateral state interference with contract rights under the guise of law. Consider that the former provisions of the two basic laws, under which a license could be unilaterally suspended or rescinded by the state authorities on certain bases, have now simply been transformed into provisions for suspension and termination of contract operations on essentially the same bases. Namely, this could be suspension for carrying out activities not provided for in the contract or the contract program, or violation of the terms of the contract, or "systematic violation" of law regarding environmental protection or safety, or a threat to life or the environment due to circumstances not caused by the user; and termination for failure to cure problems that caused suspension (or impossibility of cure), failure timely to begin the work program or carry it out adequately despite warning to cure, "material violation" of obligations under the

[4] Edict of the President having the force of law, On Land, No. 2717, dated December 22, 1995, as amended.

[5] *See* Edict of the President having the force of law, On Licensing, No. 2200 dated April 17, 1995, as amended, Arts. 9.1 (11), (12), and (13); Amending Law Art. 1.3; and Petroleum Law Chapter 6-1, Arts. 36-1 *et seq.*

contract or the work program, or bankruptcy of the contractor (Subsoil Law Arts. 45-1 and 45-2; Petroleum Law Art. 28-1).

These powers thus essentially retained by the Kazakhstan Government could be quite important, in view of the Government's actual history of challenging and revoking investors' license rights on several projects over the past few years.

In addition, with the amendments in place it is not quite clear that all disputes over extension, suspension and termination of a contract are subject to challenge in the parties' agreed international arbitration forum. This had been clear with respect to all such *license* disputes under the express terms of Petroleum Law Art. 58, but all that remains there is reference to disputes over "the entry into and performance of" contracts. Further, a contract may be declared invalid, just as a license previously could, upon establishment "in a judicial proceeding" of certain types of irregularity in the process leading up to the contract signing. (*See* Subsoil Law Art. 45 and Petroleum Law Art. 28-1.) It appears (from the language and context of this provision) that the referenced "proceeding" might be in a Kazakh domestic court, even where the contract generally calls for international arbitration of disputes. Nevertheless, the removal of the "licensing layer" from resource-use administration should, one would hope, promote enhanced respect for the sanctity of resource-use contracts under general civil-law principles.

4. State Party in Interest

Finally, there remains uncertainty under the law as to who is to be the real contract party in interest on the Kazakhstan government side. The Subsoil Law and Petroleum Law provisions (Art. 8.4 and Art. 6.3, respectively) that empower the Competent Agency to sign contracts do not directly state in whose name the Agency is signing – in its own name, or in the name of the RK Government (or of the Republic itself). Of course, the answer to this question determines who bears responsibility under the contract. (A practice that has developed to date is for contracts to be signed in the names of both the Government and the Competent Agency – and not always with clear indication of any representative capacity.)

Under basic legal analysis, it is reasonably clear that the Competent Agency must be acting for the Government and that the Government, in turn, is acting for the Republic in executing and performing a resource-use contract. (The Republic's ultimate responsibility for governmental

breaches of contract and investors' resultant damages can also be reasonably well established under Kazakhstan law.)[6]

---

[6] Succinctly stated, the analysis would be as follows:

- In Kazakhstan the subsoil, and resources therein, are the property of the Republic (*i.e.*, the State – *Gosudarstvo*). RK Constitution of August 30, 1995, as amended, Art. 6.3; Subsoil Law Art. 5.1; Petroleum Law Art. 3.1.
- The Government (*i.e.*, *Pravitel'stvo* – formerly referred to as the Cabinet of Ministers) carries out general executive authority for the Republic (Constitution Art. 64.1; Law on the Government dated December 18, 1995, as amended, Arts. 1 and 9(18)) and, more specifically, conducts "the management of the state subsoil reserves as an object of state property" (Subsoil Law Art. 7.1; *see also* Petroleum Law Art. 5.1).
- The Competent Agency appears to be acting under proper delegation of authority from the Government. Subsoil Law Arts. 1(5), 8.1 and 44.4; Petroleum Law Arts. 1 (definition of "Competent Agency"), 6.1 and 27.4; Government Decree No. 474 of April 26, 1999, as amended August 2, 1999.
- Civil-law analysis supports the same conclusion. Contract relations are, by definition, of a civil-law nature (Civil Code Arts. 1, 147 *et seq.* and 378 *et seq.*), and Subsoil Law Art. 4.3 expressly affirms that civil-law relations associated with subsoil use are governed by civil legislation (essentially, the Civil Code) except to the extent otherwise dictated in provisions of the Subsoil Law itself. Further, (*i*) under Civil Code Art. 111, the Republic may enter into civil-law relations (essentially, contracts), acting through agencies of state power and management (in this case, through the Government and, indirectly, the Competent Agency as empowered by the Government); and (*ii*) the Republic is bound essentially by the same civil-law rules as apply to legal entities (*id.* Art. 114).
- As a consequence, the law also provides that the Republic should be liable – with the assets of the "state treasury" – for its own obligations, including the unlawful actions or inactions of state agencies and officials. *See* Civil Code Arts. 9.5 and 113; Foreign Investment Law Art. 9.2.
- Further support for this analysis may be found in certain international treaties which indicate that authorized state agencies are equated to the State (the "Party" to the treaty) in the context of resolution of investment disputes. *See, e.g.*, the Kazakhstan-United States Bilateral Investment Treaty of May 19, 1992, Art. VI.1, and the Washington Convention on the Settlement of Investment Disputes Between States and Nationals of other States of March 18, 1965 (the "ICSID Convention" – signed but not yet ratified by Kazakhstan), Art. 25.

not in Russian

However, at least until such time as the Subsoil Law and/or Petroleum Law are amended further to state these subordinate capacities more crisply and clearly, investors would be well advised to try to include in their resource-use contracts (in the main text and/or the signature lines) express statements that the Competent Agency is acting for the Government and the Government is acting on behalf of the Republic – or as close approximation of such statements as possible. This would strengthen the investors' position under general private international law doctrine as well. *See, e.g., Aminoil v. Kuwait*, 21 I.L.M. 1006 (1982); W.L. Craig, W. W. Park and J. Paulsson, *International Chamber of Commerce Arbitration* 155 (2d ed. 1990); J. Paulsson, *May a State Invoke Its Internal Law to Repudiate Consent to International Commercial Arbitration?* 2 ARB. INT'L 90, 98, 102 n.34 (1986).

C. National Company and its Status: Kazakhoil

1. General: Nature and Role

The Amending Law has introduced the concept of a "National Company" (of which there may be more than one), and several special provisions establishing its legal status and rights. A National Company is now defined in the Subsoil Law as a closed joint-stock company, 100 percent of the shares of which are owned by the State, and which is established by Edict of the President "to conduct subsoil use operations directly as well as by share participation in Contracts" (Art. 1.27-1). A virtually identical definition has been added to Art. 1 of the Petroleum Law, the only difference being that the purpose of the Company is stated there to be "management of Petroleum Operations" (again, directly and by share participation in Contracts).

As distinct from other subsoil users, which now must participate in tenders to obtain rights under contract (see Section II.5. below), a National Company may obtain contract rights on the basis of direct negotiations with the Competent Agency (Subsoil Law Art. 41-1.1). Similarly, the Petroleum Law (Art. 8-2.1) provides that rights are granted to the National Company "on a non-tender basis, in a priority manner." (As a related matter, the Subsoil Law also now stipulates at Art. 41-5 ("Tender Proposals for Obtaining Resource-Use Rights") a requirement that bidders state their intention regarding share cooperation with National Companies in carrying out the project.)

Pursuant to Petroleum Law Art. 6.7-3, the National Company, together with the Competent Agency and with the so-called State Agency for Sub-

soil Use and Protection (this role presently being filled by the RK Ministry of Natural Resources and Environmental Protection), is also charged with monitoring and control over users' compliance with the terms and conditions of their contracts. New Art. 7-1 further spells out the National Company's intended functions, including (*i*) participation in strategic planning of development of the hydrocarbon resource base; (*ii*) participation in the conduct of tenders among potential contractors; and (*iii*) representation of state interests in contracts by means of mandatory share participation in contracts, together with contractors, "in the manner determined by the State."

Thus, the National Company enjoys a special legal status – carrying out state supervisory functions in respect of other subsoil users while at the same time itself acting as a subsoil user (evidently to be in mandatory partnership with private company users).

2. Kazakhoil; Blurred Mandates

JSC Kazakhoil National Oil and Gas Company is presently, and is likely to remain, the only designated National Company in the sphere of oil and gas development. It was duly established by Edict of the President No. 3378 dated March 4, 1997. By this Edict and as elaborated in Government Decree No. 410 of March 27, 1997, the State's rights under PSAs, royalty agreements and other agreements with contractors for exploration, production, transportation and processing of hydrocarbons were assigned to Kazakhoil.[7]

Because of its blurred mandate (see above), there may be uncertainty as to whether the National Company (for petroleum operations – Kazakhoil), when it "represents state interests" as co-contractor in PSAs and other resource-use contracts, will be acting in its own name or in the

[7] Other existing National Companies include JSC Kaztransoil (which conducts transport of oil) and JSC Kazatomprom (which is involved in the atomic energy industry). There is currently no National Company having general jurisdiction over hard mineral development in Kazakhstan. (JSC Altynalmaz previously played such a role, but no longer has state ownership.)

The Privatization Program for the Years 1999-2000, as approved by Government Decree No. 683 dated June 2, 1999, contemplates preparation and issuance of further specific decrees regarding national companies – namely, Rules Regulating Operations of National Companies, Rules for Holding of Tender for Selection of Top Management of National Companies, and Rules for Decisionmaking on Behalf of the State as Shareholder.

name of the State (the Republic or the Government). Here again, there is a fundamental issue of liability. Under Kazakhstan civil-law principles it would appear that, when Kazakhoil as National Company enters into PSAs or other contracts as a contracting party "in the State's interests" but in its own name, it would be deemed to bind only itself – and not the State. In doing this, Kazakhoil would, it seems, merely be a state-owned company entering into a contract as other contractors do – not a regulatory body (such as the Competent Agency). *See also* Civil Code Art. 163.4 ("Persons who act in someone else's interest but in their own names . . . are not representatives . . . .").

There is also some uncertainty (and concern) regarding the dual, possibly conflicting contract and regulatory roles that Kazakhoil may in any event have under Petroleum Law Art. 7.1. Further, it is not yet clear how such state regulatory authority will be allocated and/or coordinated between the National Company (in particular, Kazakhoil) and the Competent Agency (*i.e.*, the State Agency on Investment). Representatives of these two organizations themselves seem unsure of this, judging from recent pronouncements. However, in various statements Kazakhoil has been signaling a very broad interpretation of its overall mandate.

D. Transfer of Rights; Pledge

1. General

Subsoil Law Art. 14 has been greatly expanded, with new rules introduced that somewhat tighten the existing restrictions on transfer of rights.

First, a contractor's absolute right to transfer its subsoil-use right to a subsidiary (prior Art. 14.1) has been removed. It is now provided (in new Art. 14.9-1) that consent of the Competent Agency is required even for such transfers – but this consent may not be refused provided the parent entity has given to the Competent Agency a guarantee of complete performance of its obligations under the contract jointly and severally with the subsidiary.

Further, new Art. 14.9-1 fleshes out objective standards to govern the Competent Agency's consideration of requests to transfer rights to third parties: permission may be denied if there is not a showing that the proposed transferee is able to fulfill the user's obligations or in the event false information is submitted. Unreasonable refusals may be challenged "in accordance with current legislation and the terms of the Contract."

(Existing Art. 14.7, under which a user bears joint and several liability for contract obligations with a transferee in any case of partial transfer, is retained. *See also* Petroleum Law Art. 53.3). In the case of partial transfers, new Art. 14.9-3 now further requires that the users execute a joint operating agreement or similar agreement regarding their mutual rights and obligations, to be approved by the Competent Agency.

These amended, tightened provisions of the Subsoil Law may well have been intended to apply to oil and gas contracts as well – but inconsistent drafting in the Petroleum Law on this point presents uncertainty which might be used by some investors to their advantage. On the one hand, Petroleum Law Art. 8-3.1 states in clear language that matters of transfer of contract rights are governed by the Subsoil Law (evidently meaning the Art. 14 provisions discussed above). On the other hand, Petroleum Law Art. 53.1 also addressing transfer of rights (and obligations), has been left untouched; it still reflects the Subsoil Law's prior, easier approach to transfers – including a statement that"[t]he terms of a transfer of rights and obligations to a subsidiary organization shall be agreed in the contract."[8] This resultant inconsistency between the two laws may well be inadvertent, but because of it a petroleum contract investor seeking to transfer to a subsidiary may argue that no state approval is needed if the contract allows such transfers without it.

At the same time, Petroleum Law Art. 53.1 states expressly – as Subsoil Law Art. 14 never did and still does not – that transfer of a controlling block of shares in a contractor company qualifies as a transfer of contract rights which requires consent of the Competent Agency. Thus, there may remain less flexibility for hydrocarbon contractors on this point. The Petroleum Law (Art. 8-3.2) now also singles out for prohibition of transfer the rights to construct and operate hydrocarbon pipelines at sea.

2. Pledge of Rights

Subsoil Law Art. 15 has also been amended, but the changes may not be significant in practice. New Art. 15.2-1 provides that a pledge of subsoil-use rights no longer requires permission of the Competent Agency per the Art. 14 procedures; nor must the contract be re-executed in the name of the pledgeholder. However, a pledge contract still must be "registered" by the Competent Agency, and is effective only upon such

[8] In the Amending Law drafting process there was a proposal to eliminate this Art. 53 and the confusion it causes in light of new Art. 8-3.1, but that did not happen.

registration. At the same time, Art. 15.2-4 spells out some possible grounds for refusal to register, including: "absence of adequate terms of the pledge of rights for the resource user in comparison with the conditions applied in the domestic or international market in similar circumstances. . . ."

E. Granting of Subsoil Use Rights; Tender Requirement

The procedures for granting of rights (for exploration, production, and combined exploration and production) have been elaborated and tightened in some respects. The Government is now to approve an annual list of subsoil blocks put out for investment tender. (Parliamentary approval is not also needed, unlike the situation for PSA fields in Russia.) Tenders may be open or closed, conducted under rules of the Subsoil Law (Arts. 41-1 to 41-7) that have changed little from those that governed previously. The big change is the new rule that would-be users may obtain contract rights only through the tender process. Subsoil Law Art. 41-1.1; Petroleum Law Art. 8-2.1. (Previously, tenders were supposed to be held "as a rule," but direct negotiations without tender were allowed and were often pursued by the Government in practice.)

The only exceptions from tender now permitted are (*i*) for an exploration contractor who makes a commercial discovery, who then has an exclusive right to enter into a production contract on the basis of direct negotiations (Subsoil Law Art. 64); (*ii*) as noted above, for a National Company, which obtains rights on the basis of direct negotiations (Art. 41-1.1); and (*iii*) for commercial production of widespread minerals, and for construction or operation of underground structures not related to exploration or production of resources, both also allowed without tender (*id.*).

Neither law addresses the situation where there is only one bidder in a tender. We think that in this case the rules of civil legislation should be applied by analogy. Namely, RK Civil Code Art. 915.4 provides that "a tender *may* be invalidated by its organizer if it has fewer than two participants or if the proposals of the tender participants are considered by the organizer not to correspond to the terms of the tender" (emphasis added). It would follow from a literal interpretation of this rule that if the tender may be declared invalid, it may also be declared valid. This might occur, for example, where the sole participant in the tender *does* meet the required criteria established by the organizers. In such case where there is a sole bidder, tender procedures should still be observed to the extent appropriate.

F. Types of Contracts; Status of PSAs; Adherence to Model Contract

1. General

The list of types of contracts anticipated to be entered into has changed. In part, this merely reflects the shift away from the license-based system. The contract is now the sole "carrier" of the underlying rights. Thus, the types of contracts are now stated to be essentially those that used to characterize licenses: *i.e.*, contracts for exploration, for production, for combined exploration and production, and for construction/use of subsoil structures unrelated to exploration or production (*e.g.*, construction of underground storage reservoirs). This understanding of the basic types of resource use has not changed. Subsoil Law Art. 42.1; Petroleum Law Art. 25.1.

2. Production-Sharing Agreements

The contract types previously named in the law (production-sharing, concession, service, and joint activities) corresponded to types of commercial relationship. Interestingly, of these only a reference to PSAs has survived – and this only in the Petroleum Law list of contract types (Art. 25.1) and *not* in the Subsoil Law list. This has led some commentators to conclude – erroneously, in our view – that the PSA form has somehow been "demoted" or disapproved for use.

There *is* possibly an intent in the new law to signal that PSAs are suitable for oil and gas but not hard mineral development projects. However, this would only reflect the reality of the marketplace; while the PSA form has been available under the law of Kazakhstan (as in Russia) for all subsoil mineral development projects, in practice it is being used only in the oil and gas sphere. (A few hard mineral PSAs have been approved and may be going forward in Russia but there have been none in Kazakhstan to date as far as we are aware.)[9]

Further, we do detect some frustration of Kazakh government officials with the administrative difficulties presented by the PSA form generally – the need to apply a special, *ad hoc* legal regime having several deviations from standard rules of law, etc. And in Kazakhstan, unlike Russia, there is no special law on PSAs – only the resource-use chapter of the Tax Code

[9] In our view, the letter of the law would support a hard mineral contractor's use of the PSA form if there were a desire to proceed in this way. *See* Subsoil Law Art. 42.2 (allowing "other forms of Contracts").

which expressly provides a special tax regime for PSAs (*see* Tax Code Art. 94-1), and various isolated provisions in the Subsoil Law and Petroleum Law that can be applied for purposes of a PSA.[10] Thus, there is a sense that, as a practical matter, PSAs may be discouraged by the RK Government in cases of routine projects where no convincing showing of need for the special regime has been made. But we do not think that oil companies will be barred from going forward in PSA format for appropriately large and/or difficult fields. (Again, Petroleum Law Art. 25.1(3) still expressly provides for PSAs.)

It will be interesting to see what sorts of contract terms and forms the RK Government will propose in tenders for rights to important fields in the future. Finally, perhaps needless to say, existing PSAs are protected – in form and substance – by the various stabilization provisions in the law and in those contracts themselves (see Section III below).

As for the service, joint activity and concession forms of contract previously mentioned in the law, we suppose that these and other possible forms will still be welcome – as an adjunct to or independent of main development contracts, as appropriate. *See* Subsoil Law Art. 42.2 ("[d]epending on the conditions of the concrete Resource-Use Operations and other circumstances, . . . other forms of Contracts shall be permitted"), and Petroleum Law Art. 25.2 to the same effect.

3. Contract Terms; Model Contract

As noted above, the law now states expressly and clearly that "the terms of a Contract must accord with [RK law]" and that "Contract terms contradicting the legislation in effect at the time of execution of the Contract shall be considered invalid." Subsoil Law Art. 42.2-2; Petroleum Law Art. 26.5. This must be kept well in mind, particularly in the context of entering into a PSA where some "standard" international industry terms may run afoul of (or, in any event, do not find clear support in) Kazakhstan law.

---

[10] *See, e.g.*, the provisions on cost recovery (Subsoil Law Art. 64.3 and Petroleum Law Art. 30-6), ownership of property and transfer thereof (Petroleum Law Art. 30-7), and retention of gas fields (Petroleum Law Art. 30-4). See Section II.10 below for further discussion of these and other miscellaneous new or revised provisions of the two laws. The amendments here are not fully helpful in all respects.

Both laws (Subsoil Law Art. 42.2-1; Petroleum Law Art. 26.6) also state that "the terms of a Contract shall be determined by mutual agreement of the parties, taking into account the provisions of the Model Contract." This statement is not new to the laws. There is an officially-approved Model Contract: the current version is the Model Contract for Carrying Out Resource-Use Operations, confirmed by RK Government Decree No. 108 of January 27, 1997. This is a generic, all-purpose document, not geared to PSAs in particular. It certainly is not satisfactory from Western investors' point of view in all respects. It is not clear whether the Government intends to adopt a specific model contract for PSAs. At the very least, if the existing Model is intended to be used, it will have to be updated to incorporate all of the Amending Law changes.

There may be some uncertainty over whether the Model Contract's provisions are considered mandatory or only guidelines for negotiation. Decree No. 108 cited above instructs competent agencies of the Government, "in preparing and concluding resource-use contracts, to be governed *[rukovodstvovat'sya]* by the provisions of the Model Contract." However, the definition of Model Contract in the Subsoil Law (Art. 1(13)) refers to it only as a "sample contract" and says that "it shall be utilized *as an example* in preparation of Contracts" (emphasis added). Thus, it is fairly clear in our view that all of the terms of the Model Contract cannot be considered to be mandatory. This follows from all of the above-cited references in the two laws.

Our recent experience is that officials of the Competent Agency and other relevant state bodies have come to understand this as well: they have tended to agree that the only Model Contract provisions that are mandatory are those that parrot mandatory provisions of the law.

G. Preference for Local Goods and Services

The existing requirements for favoring local suppliers of goods and services have been stiffened and may cause problems for investing companies, depending on how the law is administered by the RK Government.

1. Basic provisions: Prior Versus Current Law

Previously there were manageable requirements that Kazakhstan-produced equipment, materials and other goods be given preference if competitive in quality (both ecological and technical), price and delivery terms, and that local service (including transport) providers be given

preference if competitive in price, efficiency and quality. Now both the Subsoil Law (Arts. 63(7) and (8)) and the Petroleum Law (Arts. 41(6) and (7)) state more absolutely that it is "mandatory" for resource-user companies to use goods "produced in Kazakhstan", and services provided by "Kazakhstan enterprises and organizations," if such goods or services "comply with standards and other requirements within a tender conducted in Kazakhstan in the manner determined by the [RK] Government."

2. New Affirmative Permission Requirement

New Art. 63.8-1 of the Subsoil Law then adds, with respect to services: "In the event of absence of some type of service in . . . Kazakhstan, the services of foreign organizations may be used by permission of the state agency." This appears to establish a rule that it is not enough for a foreign investing company to hold a fair tender in Kazakhstan under state-mandated rules, conclude that there is no appropriate Kazakh service provider available and then turn to a foreign provider; rather, in such case the investor could then *also* have to receive affirmative government permission before awarding the contract to a foreign firm. (Curiously, while the basic tender requirements for goods and services providers are stated in both laws, this affirmative permission requirement is not restated in the Petroleum Law. This may simply have been a drafting error. In any event, because of the partial overlap and repetition of provisions in the two laws, there will be some uncertainty over whether the requirement is or is not intended to apply to hydrocarbon projects. For now, one may reasonably take the position that it is not so intended.)

3. General Analysis: Path to Solution

These Kazakhstan supplier amendments presumably were introduced as a result of political pressure to maximize benefits from the current mineral development boom to the local economy – as was the case with recent amendments to Russia's PSA Law. However, while Russia's new 70 percent quota for local suppliers at least sets a predictable rule (and applies only to goods, not services), the new Kazakh law requirement – being at once absolute and devoid of objective standards – could cause even greater difficulties. This is all the more so in view of the evident (*i*) scarcity of high-quality suppliers of the needed goods and services in Kazakhstan even as compared with Russia, and (*ii*) additional requirement of affirmative government permission to engage foreign service providers once a tender has been held. The hope is that the contemplated tender rules to be developed and issued by the RK Government will reintroduce workable, objective standards and realistic expectations to the process. (Note that such strict national supplier preference rules may also cause

problems for Kazakhstan in connection with its pending application for membership in the World Trade Organization.)

In any event, an obvious avenue for satisfying the requirements has been and should remain the establishment and operation of joint venture companies in Kazakhstan between qualified foreign suppliers and local partners, to be deemed a "Kazakhstan enterprise" and to make goods "produced in Kazakhstan." This has been the strong trend of development in Russia (particularly in the Far East in connection with the Sakhalin projects), and it is likely to occur in Kazakhstan as well. It will be interesting to see how broadly or narrowly these "produced in Kazakhstan" and "Kazakhstan enterprise" criteria will be defined and applied in practice.[11]

H. Governing Law

There has been a notable step backward as well with regard to governing law for resource-use contracts.

Previously, both the Subsoil Law and the Petroleum Law provided that, except on points where application of Kazakhstan law was expressly required, the parties were free to have their contract relations governed by the law of another country. This rule was consistent with general principles of private international law as applied in Kazakhstan and now recodified in the new RK Civil Code – see below. In practice this has meant that foreign companies legally could get the RK Government to agree to foreign law (perhaps of England, Sweden, etc.) to govern contract disputes under a PSA or other contract, while it was understood that in any event Kazakh law would apply to matters of actual project operations in Kazakhstan (that is, environmental, safety, labor and tax laws, etc.).

Now these basic understandings have changed, at least for oil and gas projects. The prior permissive "Applicable Law" definition has been

[11] It is likely that equipment and other goods would not be considered "produced in Kazakhstan" if they are merely imported by a newly formed local joint venture company from the foreign supplier partner, and sold (or resold) by the JV without any local value added. To be safely considered a "producer", the local JV should at least have an assembly if not an outright manufacturing function, and not act simply as a sales agent between a foreign supplier and Kazakhstan project contractors. Analogous caution should be observed with regard to provision of services through local JVs.

removed from both laws. In its place there is a new Article 53-1 of the Petroleum Law. It states bluntly:

> "(1) The law of the Republic of Kazakhstan exclusively shall be applied to relations for the conduct of Petroleum Operations being carried out [on RK territory on land and at sea].
>
> "(2) Terms calling for application of foreign law may not be contained in Contracts being concluded with the Competent Agency . . . ."

This will likely be taken to mean that henceforth no PSA or other resource-use contract entered into with the State may provide for foreign applicable law, even just to govern the parties' contract disputes (although a narrower, less restrictive interpretation might still be possible).[12] Subsoil Law Art. 4.3 and Petroleum Law Art. 2.3 would provide further support for this conclusion. (This rule should *not*, in any event, prevent foreign companies from insisting on application of foreign law to govern the various kinds of related agreements that may be entered into, as adjuncts to the main resource-use contract, with other Kazakhstan parties.)

We note that no such restrictive provision has been added to the Subsoil Law – so that that law is left without any statement on governing law for contracts. Here again, it is unclear whether this omission was inadvertent or purposeful. The result, in any case, appears to be that in hard mineral development projects, which are governed by the Subsoil Law alone, general civil-law principles on choice of law for international contracts would apply (see RK Civil Code Arts. 1102, 1112-1115).[13] Those principles should allow the choice of foreign law to govern a hard mineral-use contract entered into between a foreign company-investor and the RK Government (or agency thereof). What the responsible state agencies will or will not agree to in negotiations is another matter.

---

[12] The only exception, stated in Art. 53-1.3, is for hydrocarbon development projects being carried out along marine boundary areas at sea (*i.e.*, the Caspian or Aral Seas), where application of the other state's law is permitted if so provided for in a treaty (such as the Caspian Sea delineation treaty signed last year between Kazakhstan and Russia but evidently not yet ratified). Such a concession on applicable law for projects in these marine boundary zones may be useful in facilitating unitary field development in those areas.

[13] These articles of the Civil Code appear in Chapter 62 ("Conflicts Norms") within the so-called "Specific Part" of the Code which was recently enacted, as of July 1, 1999. The entire new Civil Code is now in force, and can be helpful in the analysis of various issues arising in connection with resource-use contracts – as we indicate at a number of points herein.

maximally low level of Sea Pollution or wholly excluding Sea Pollution");

- *strict liability*, regardless of fault, "for damage and losses caused to the environment and to natural persons or legal entities in the event of Sea Pollution directly or as a result of a rise in sea level following pollution of the Coastal Protected Zone" (Petroleum Art. 36-1.3; Subsoil Law Art. 48-1.2).

2. Marine-area Protection

Plainly, the perceived need to protect the Caspian Sea and adjacent coastal areas in light of the current and impending major hydrocarbon development projects there and the rising level of this sea in recent years was the driving force for these amendments. (They will be applicable to project work affecting the Aral Sea and other internal waterways as well). The above-noted definitions and standards of care, and a number of additional obligations, are applied here with great specificity (which may well encourage and assist adverse claims), if not with perfect clarity, or consistency.

Petroleum Law Art. 36-1 is the core new environmental provision. It directs the following:

- Contractors are to conduct petroleum operations at sea "such as not to be an obstacle for or cause harm to shipping, fisheries or other appropriate activity usually carried out in that particular area of the sea." (At the same time, persons carrying out such other activities must observe the 500-meter Safety Zone rules around Marine Structures.)
- Petroleum operations contractors must follow the Best Practice of Marine Environmental Protection Standard.
- As noted, strict liability is imposed for Sea Pollution (as broadly defined – see above).
- Petroleum operations contractors must develop, have approved and implement detailed programs for prevention of Sea Pollution in the event of accident, etc.
- If there is Sea Pollution despite the accident-prevention measures, contractors must take "all possible measures for elimination or reduction of the level [thereof], by all available means."

- Contractors must provide, at their own expense, opportunities and transport for government-authorized inspectors regularly to inspect Marine Structures being used in petroleum operations.
- Special state permission must be obtained for the construction or placement of Marine Structures.

There are also these further new Petroleum Law permitting requirements and restrictions:

- special state permissions for any kind of drilling (whether for survey, exploration or production) and for gas injection, and obligations to have on hand adequate materials and procedures for clean-up of spills (Art. 36-2);
- special state permissions for construction and/or use of undersea oil and gas pipelines (Art. 36-3);[15]
- prohibition of construction or use of petroleum storage facilities or reservoirs at sea, or of storage on Marine Structures with the exception of temporary storage (for no longer than 20 days) in connection with transport of such petroleum by tanker directly from the site (Art. 36-4);
- special state permission and requirements for construction and use of Marine Structures, observance of the Safety Zone around them, warning to third parties of their existence, disassembly/removal etc. (Art. 36-5); and
- special insurance coverage requirements for risks associated with exploration and production operations at sea (Art. 55.3-1).

The Petroleum Law also restates at Art. 36-6, in terms virtually identical to those stated previously but perhaps insufficiently noted, strict requirements for "Discharge and Burial of Waste Associated With Petroleum Operations at Sea." Discharge or burial of such waste is "prohibited," and "[d]isposal of technical waters into the Sea may be carried out only with the permission and under the supervision of the state

[15] Note, in addition, the existing (and remaining) Chapter 8, Arts. 42 - 45 of the Petroleum Law, on "Trunk Pipeline Transportation." The law there provides, among other things, for non-interference by local authorities in the operation of these pipelines, and for pipeline owners (including private owners) to accept product from third parties for shipment in the event of spare capacity. Also, various provisions of the Energy Charter Treaty could be pertinent for the operation of pipelines in Kazakhstan. (Kazakhstan has ratified the Treaty and it is now in effect among those 40 nations – *not* including Russia or the United States – that have ratified it to date.)

supervisory agencies, [and] on condition of their being cleaned to established normatives." Hydrocarbon project contractors will want to consult carefully on the meaning and application of these rules with respect to drilling muds and cuttings, etc. – particularly in view of recent problems with the state authorities in Russia in this regard.

Perhaps inadvertently, the Amending Law failed to delete or revise pre-existing Art. 49 of the Petroleum Law (that being a cursory provision on petroleum operations at sea) in connection with enactment of the much more detailed new articles. This would be a harmless oversight except for the Art. 49 requirement of approval *by the President of Kazakhstan* for petroleum operations at sea. There are various ways this provision might be dealt with by interpretation, but it could raise questions about proper authorization for offshore projects – and would best be clarified (or deleted) by further amendment.

3. Coastal Protected Zone

As is well known, the level of the Caspian Sea has risen dramatically over the past decades, perhaps due to natural geological (plate tectonic) forces in the sub-sea area. This phenomenon has caused the sea to "capture" a very large area of what used to be flat coastal plain in western Kazakhstan. And there has been real concern that pollution of coastal land areas in the course of petroleum operations could, with further such rise in the sea level, become more serious marine pollution. While the steady rise is actually reported to have ceased in the past few years, the lingering concern has spawned amendments to the Subsoil and Petroleum Laws (Arts. 48-1 and 30-9, respectively) to guard a newly established Coastal Protected Zone, which extends five kilometers inland from the sea (and which, presumably, would "migrate" in the future as the sea rises further or subsides).

Thus, subsoil development operations in these Zones must be conducted "so as to exclude or maximally reduce Sea Pollution in the event of rise in the level of the sea waters." As noted, strict liability is imposed for damage to the environment or persons or companies for Sea Pollution as a result of Petroleum Operations in such a Zone and subsequent rise in sea level.[16]

[16] We note that Petroleum Law Art. 30-9.2, the provision regarding liability for pollution of the Coastal Protected Zone, does not include the formal phrase that in Russian makes clear the same "strict liability" meaning that is expressly stated in the parallel Subsoil Law Art. 48-1.2. We guess that this omission was inadvertent, although one could try to argue otherwise.

As is the case for petroleum operations at sea, detailed programs for protection and cure of accidents must be developed, approved and implemented (Petroleum Law Art. 30-9.3), and in the event of Sea Pollution the contractor must take "all possible measures" for "elimination or reduction of the danger of consequences" by "all available means" (*id.* Art. 30-9.4). This last provision, regarding actual pollution of the sea from operations in the Coastal Protected Zone, could well be interpreted to apply not only upon a further rise in sea level into the Zone but also in the event of spillage or seepage of pollution from the Zone into the nearby sea at the existing level.

J. Certain Other New or Revised Provisions

The Amending Law has introduced other specific rules and changes into the two laws, a number of them under Subsoil Law Art. 64 ("Terms of Conducting Resource-Use Operations") and Petroleum Law Art. 30 ("Terms of Conducting Petroleum Operations") *et seq.* Some of these changes add burdens for investors, some are advantageous, and others are mixed. We only mention certain of them here:

1. Commercial Discovery

An exploration contractor's reporting and evaluation obligations upon discovery of a deposit that may be commercial are more clearly stated. On the other hand, it is also now expressly provided that such a contractor who makes a commercial discovery has the exclusive right to obtain production rights, on the basis of direct negotiations (*i.e.*, without a tender). Subsoil Law Art. 64.1 and .2; Petroleum Law Arts. 30.4 and .5, 30-3.

2. Work Programs

The requirements of establishing minimum and annual programs, in accordance with Kazakhstan law, are tightened. Subsoil Law Arts. 64.1, 64.3-1 *et seq.*; Petroleum Law Art. 30-1.

3. Cost Recovery

These rules are tightened and sharpened somewhat as well. Both laws previously had provided simply that resource-use project costs could be recovered in accordance with the contract in the event of commercial discovery, and there is a brief governmental regulation on the subject. Now (*i*) Subsoil Law Art. 64.3 has added provisions barring recovery of costs that are "unjustifiably high," do not accord with Positive Practice of

Development of Deposits, or were incurred in connection with a violation of rules or norms established by law or contract; and (*ii*) new Art. 30-6 of the Petroleum Law adds some further restrictions as to timing and amount of cost recovery in hydrocarbon development projects and provides for carry-forward of unrecovered costs.

4. Property Ownership and Transfer; Related Obligations

Petroleum Law Art. 30-7 now provides: "Matters of transfer of rights of ownership of equipment and other property . . . used by the Contractor for carrying out Exploration and Production, as well as compensation for such transfer, shall be determined in the Contract." Art. 30-7.2 and .3 then provide that, despite any transfer of rights to the State, unless otherwise provided by contract the contractor retains the obligation to disassemble and/or remove such property from the contract territory, at its own expense and by safe and effective means, upon demand by the proper government authorities.

5. Gas Deposit Retention; Mandatory Sales

New Art. 30-4 of the Petroleum Law sets forth some helpful principles but then circumscribes their use. It is first stated that exploration and production of a commercial deposit of natural gas must proceed apace, unless otherwise provided by contract. Then it is provided that (*i*) state authorities may not require commencement of production of such a deposit until appropriate agreements of sale are executed, and (*ii*) unless otherwise provided by the contract, the term of the development contract is tolled pending execution of sale agreements. However, if such a sale agreement has not been executed within a year of commercial discovery, the State may demand execution of such agreement with designated third parties – and if the contractor and designated third party cannot come to agreement the matter may be resolved "by judicial means."

6. Flaring of Gas

Petroleum Law Art. 30-5 sets a general requirement of a contractor's obtaining advance written permission for flaring of associated or natural gas in connection with exploration or production operations, with the exception of certain cases of necessity (in which cases notice must be given and approval then obtained).

7. Unitary Field Development; Joint Operations

New Petroleum Law Art. 31 spells out procedures and requirements in the event that one contractor's deposit is found to extend beyond the contract territory and/or to merge into a deposit in another contractor's territory. The options, depending on the precise circumstances, include redefinition of the contract territory, transfer of rights from one contractor to another, or execution of a joint operating agreement for the exploration and production work. In the event voluntary agreement is not reached, the Competent Agency may force the conclusion of such an agreement for joint development "by judicial means" if necessary. It is stated generally that contractors carrying out joint exploration and production "bear joint and several liability for fulfillment of the obligations imposed on them in the Contract as well as by [the applicable work programs]." This latter provision (Art. 31.5) will likely be interpreted to apply not only in the event of subsequent agreement on joint activities under Art. 31, but in all cases of joint operation by an unincorporated consortium. (*See also* Subsoil Law Art. 13.4-1.)

8. Easements

The concept of easements (servitudes), initially introduced into Kazakh law by the Land Code in 1995, is expressly applied in the subsoil-use context. (Subsoil Law Arts. 1.25-1, 11-2.) An easement may be granted to one person, to provide him with justified limited right of use of or access across another person's subsoil plot, by the state agency for use and protection of the subsoil (the Ministry of Natural Resources and Environmental Protection) "by agreement with" such other person and the Competent Agency. Further restrictions and procedures are stated.

III. Sanctity of Existing Licenses and Contracts

The matter of stabilization of the legal regime governing existing resource development projects is quite important – all the more so given the major changes in law that have just occurred. But the analysis of stabilization in a generalized manner is difficult, because of all the possible aspects and permutations of particular projects and the delicate interaction among relevant legal provisions. Here we only set forth the basic components of analysis under current Kazakhstan law.

At bottom, one must keep in mind that any article of law that grants stabilization, "grandfathering" or similar protection to pre-existing contracts cannot be relied on fully – because it may be altered or rescinded

by the national legislature at any time. (Indeed, there has already been some such narrowing of the stabilization provisions in Kazakh law over the past few years, as pointed out below.) Thus, it is always wise practice to buttress one's legal position with the strongest and most comprehensive possible stabilization provisions *in the investment contract itself.* That may provide the basis for a favorable arbitration ruling and award of damages regardless of any harmful legislative actions. (Of course, project-specific special legislation, presidential edicts and government decrees offering added stabilization protection may be of great help as well, where obtainable.)

A. Provisions in the Amending, Subsoil, and Petroleum Laws

The Amending Law itself contains a stabilization provision (Art. 2.3), which states:

> "All resource-use licenses issued up to the time of entry into force of this Law [*i.e.*, September 1, 1999] shall retain their effect until the expiration of their term, including extension, in accordance with [RK] legislation in force at the time of issuance of such licenses. With respect to suspension, revocation and termination of effect, as well as recognition of resource-use licenses as invalid, the provisions of [the Subsoil Law], without taking account of the changes and additions enacted in accordance with [the Amending Law], shall apply."

This provision appears clearly to be aimed at calming concerns of all existing resource-use licenseholders, in the face of the Amending Law's elimination of licensing altogether.

This naturally raises the question: what about stabilization of all the present *contracts* that have existed alongside the licenses and that spell out investors' rights and obligations in detail? Expansion of Amending Law Art. 2.3. to cover contracts as well might have been an ideal way to reinforce this comfort; but we believe the matter of contract stabilization is covered adequately, if not perfectly, elsewhere in the Subsoil and Petroleum Laws – as well as in pertinent provisions of the Civil Code, the Foreign Investment Law and, with regard to taxation, the Tax Code.

The Subsoil Law and the Petroleum Law have virtually identical provisions in this regard. First, it is stated (and not changed by the Amending Law): "Licenses issued and Contracts entered into before entry into force of this [Law], as well as all associated acts of [RK] executive bodies, shall retain their effect." (Subsoil Law Art. 73.2; Petroleum Law Art. 2.5.) This is directed at "grandfathering" the special terms contained

in project licenses and contracts, and their associated special presidential edicts and government decrees, etc. – such as were issued to benefit Tenghiz Chevroil – that predate enactment of the two laws (June 1995 for the Petroleum Law and January 1996 for the Subsoil Law).

Both laws, again in near identical language, also contain the following helpful provision (albeit recently tightened by the Amending Law, as shown here in italics):

> "The [resource-user] shall be guaranteed the protection of its rights in accordance with law. All changes and additions to legislation that worsen the position of the [resource-user] shall not apply to Contracts entered into before such changes and amendments. *The guarantees established by this article shall not extend to changes in [RK] legislation in the areas of national defense and national security, environmental protection and public health.*"

(Subsoil Law Art. 71; Petroleum Law Art. 57.) Note that this provision expressly had covered licenses as well – until the Amending Law, having its own Art. 2.3 regarding pre-existing licenses, deleted the word "Licenses" here.

This adds protection for the more recent contracts entered into since the two laws came into effect – but now the protection exists only as narrowed by the Amending Law language italicized above, which carves out amendments of law on defense, security, the environment and health from stabilization.

This provision as it now stands may be of real importance in view of the strengthened environmental protection requirements just introduced by the Amending Law (see Section II.9. above). It appears to us that these Amending Law changes (on the environment, etc.) likely *would*, because of the applicable carve-out, be interpreted to apply to post-1995 contracts that are otherwise stabilized, although argument could be made to the contrary. There is then the further important interpretative question of whether this carve-out will apply even to the grandfathered pre-1995/96 contracts. Here again, given the existing and newly reinforced statutory constraints on stabilization protection, the Government likely will now take the position that the recent environmental law changes – and any future environmental, public health and national security changes in law – will apply even to those oldest contracts.[17]

[17] Further clouding the analysis is Subsoil Law Art. 73.1, which provides (unaffected by the Amending Law): "This [Law] shall apply to resource-use

B. Foreign Investment Law Provisions

In any event, this environmental-law carve-out conforms to very similar language within the stabilization article (Art. 6, "Guarantees from Change in Legislation") of Kazakhstan's Law on Foreign Investment, dated December 27, 1994, as amended (the "FIL"), which article can and should also be relied on by some hydrocarbon and other mineral-resource project investors. *See, e.g.*, Subsoil Law Art. 4.4. (Normally the FIL would be understood, without question, to protect foreign investors in Kazakhstan PSAs. However, a recent amendment to the FIL casts that "easy" conclusion into some doubt.[18])

FIL Art. 6.1 initially states the broad guarantee that is accorded to foreign investors:

> "In the event of a worsening of the position of a foreign investor as a result of changes in legislation and/or entry into force and/or changes in the terms of international agreements [*i.e.*, treaties], the legislation in effect at the time of the making of the investment shall apply for 10 years, and for investments being carried out under long-term (greater than 10

---

relations and other legal relations arising after its entry into force. With regard to [such] relations arising before its entry into force, this [Law] shall apply to those rights and obligations that have arisen after its entry into force."

While its scope of application in practice is hard to predict, this provision could lend added support to the view that even the earliest "grandfathered" investors have at least to abide by unfavorable changes in the Subsoil Law (*e.g.*, tightened rules for environmental clean-up) that affect matters that had not yet arisen in the project until after the new Law was in place.

[18] Art. 1 of the FIL underwent a set of amendments in August 1999, evidently intended to extend the benefits of the law to Kazakh companies having foreign shareholdings (*e.g.*, foreign investors' local subsidiaries). One of the changes was the specification of a new definition for "foreign investment" (such investments being the object of the protection afforded by all of the guarantees contained in the law, including Art. 6, as follows: "Investments carried out in the form of participation in the charter capital of [RK] legal entities, as well as the granting of loans (credits) to [RK] legal entities with respect to which foreign investors have the right to determine decisions."

Thus, except in cases where one or more foreign companies pursue their Kazakh PSA investment through a locally-incorporated legal entity (which is not the required or common approach), a PSA investment could well not satisfy this new definition of "foreign investment". One assumes that this result is inadvertent, but the analysis would appear to be the correct one under the current literal language of the law.

years) contracts with authorized state agencies – to the end of the term of the contract, unless otherwise provided by the contract."[19]

FIL Art. 6.3 then states a carve-out from stabilization protection nearly identical but slightly broader in terms than that just added to the Subsoil and Petroleum Law – covering amendments to law "in the areas of national defense, national security, environmental protection, public health *and morals*" (emphasis added). Art. 6.3 goes on to provide:

> "In the event of a change in legislation worsening the position of a foreign investor in these areas, the foreign investor shall be paid prompt, adequate and effective compensation in the currency of the investment or in a foreign currency determined by agreement of the foreign investor and the [RK]."

While there is no such change-of-law compensation provision in the Subsoil or Petroleum Laws, this FIL provision should be applicable to resource-use projects (subject to the above-stated caution regarding PSAs and the recent FIL amendments). It is best, in any event, to include such a provision in the contract itself.

Moreover, the RK Supreme Soviet decree that accompanied enactment of the FIL expressly gave retroactive force to FIL Article 6. It states: "Article 6 of the Law applies to legal relations that arose prior to the Law's entry into force."[20] This provision serves to confirm that all foreign investors, as covered by the FIL, already were subject to an environmental-law carve-out from stabilization protection; thus, there would be nothing

---

[19] FIL Art. 6.1 then also provides that in the event of an *improvement* of the foreign investor's position due to such change in law or treaty, "particular provisions of contracts between a foreign investor and an authorized state agency representing the Republic may be amended by mutual agreement of the parties, with the goal of achieving a balance of economic interests of the participants." (Note that this procedure is stated to be *voluntary*, although we suppose that the Government would cite this provision and apply pressure for amendment, either directly or through a judicial proceeding, should the right circumstances arise.)

Art. 6.2 clarifies that the main Art. 6.1 guarantee of stability in the event of deterioration in the investor's position extends for the full term of the applicable license including extensions, in cases where the investment is made on the basis of a license. This provision would no longer be pertinent for new resource-use projects, but does further buttress the stabilized position of pre-existing licensed projects.

[20] RK Supreme Soviet Decree dated December 27, 1994, as amended March 3, 1995 (the "FIL Implementing Decree"), para. 2.

remarkable in understanding the similar Subsoil Law and Petroleum Law carve-outs to apply retroactively as well.

C. The Civil Code

As noted above, the RK Civil Code, which is Kazakhstan's fundamental act of civil law, affords additional support for the stabilization of resource-use contracts. Article 383 provides:

> "1. A contract shall comply with rules that are mandatory for the parties as established by legislation (imperative norms) in effect at the time the contract is entered into.
> "2. If, after a contract is entered into, there shall be established by legislation rules that are mandatory for the parties, other than those that were in effect upon the contract being entered into, the terms of such contract shall retain their force, except in cases where legislation establishes that its effect shall extend to relations arising from contracts previously entered into."

This basic civil-law rule for contracts certainly applies to resource-use contracts entered into with RK government agencies. See Civil Code Art. 111; see also Subsoil Law Art. 4.3, which confirms that "civil-law relations associated with the right of resource use shall be regulated by the norms of civil legislation, unless they are regulated by norms of this [Law]." And note that the above-quoted Civil Code Art 383.2 does allow for retroactive application of a new law – but only if said law expressly so provides. This provision, taken together with the final caveat of Subsoil Law Art. 4.3 as well as Subsoil Law Art. 73.1, FIL Art. 6 and the FIL Implementing Decree (see above), further tends to underscore the case for application of the newly-introduced Subsoil and Petroleum Law stabilization carve-out for changes in defense, environmental or health-related law to previously concluded resource-use contracts.

D. Tax Stabilization

Stabilization and grandfathering protection from changes in tax legislation for resource development contracts entered into at various points over the past years is another matter of crucial importance, which has been the subject of much attention and a series of amendments to the RK Tax Code.[21] Of course the Tax Code has its self-contained provisions

[21] Edict of the President having the force of law, On Taxes and Other Mandatory Payments into the Budget, No. 2235, dated April 24, 1995, as amended most recently on March 31, 1999.

setting forth the regime of taxation and related payments for resource projects (Chapter 21, Arts. 94 *et seq.*). Here we will only note the Tax Code's own stabilization terms.

The generally applicable provisions are Arts. 94.2 and 94-3.1, which should be read together. They establish (*i*) that a resource-contract tax regime must be in accord with the tax law in effect at the time the contract is entered into, and (*ii*) such contract tax regime (as approved by state tax expert review) shall be stabilized through the end of the contract term – unless there is mutual agreement to changes that do not alter the balance of initial economic positions of the parties.[22]

There is also Tax Code Art. 179.4, covering the grandfathered pre-1996 project contracts. It states that:

> "tax provisions contained in contracts . . . entered into before January 1, 1996, as well as in contracts . . . entered into after the date in furtherance of earlier executed contracts with [the same] resource user, and in contracts . . . that passed through mandatory tax expert review [before that date but] executed after January 1, 1996, shall be preserved and be in effect for the full contemplated term of their existence."

Note, finally, Tax Code Art. 2.4, which establishes that exemptions from or reductions of any taxes established in the Tax Code may be adopted only by (*i*) amendment to the Tax Code itself, or (*ii*) a contract with the RK State Agency on Investment (under a special legal mechanism that by current law is not applicable to mineral development projects). This statement of law, like some of the others noted above, helps to fuel the difficult questions as to the intended interaction among the various stabilization provisions for different purposes.[23]

---

[22] Art. 94.2 (second para.) adds that, in the event of execution of a new contract with the same user or its successor, in furtherance of an existing contract [*e.g.*, a contract for the next stage of activity at the same field], the tax regime established in the initial contract shall continue to apply only to the extent expressly so provided therein.

[23] For further discussion on this subject, *see* M. K. SULEIMENOV AND Y. G. BASIN, eds., Commentaries on the Civil Code of the Republic of Kazakhstan (General Part), Volume 2, Art. 383, (Almaty 1998) at 311-15. *See also* A. T. Kenjebaeva, *The Issues of Stabilization and Grandfathering of Licenses and Contracts in the Context of the New Subsoil Amendments*, paper presented at the 7th Annual Kazakhstan International Oil and Gas Conference (KIOGE), October 6, 1999. (Ms. Kenjebaeva raises some interesting questions as to possible interpretation and application of Amending Law Art. 2.3, although we do not agree with all of her analysis and conclusions.)

E. Further Considerations

Once it is determined that the terms of a contract (and/or license) are entitled to stabilization such that the laws and regulations as of a certain date remain applicable in "frozen" form without regard to subsequent changes, there will still be difficulties. First, even if the Government is willing to honor this commitment, it will not always be easy to disentangle and isolate those old rules for application – particularly bearing in mind that both unhelpful and helpful amendments may have been introduced and be bound together in "packages", and that some areas of amendment (environmental protection, etc.) are carved out from grandfathering protection. Further, if the Government has changed the law and is *not* willing to honor its stabilization commitment to particular investors, an arbitral tribunal is unlikely to order Kazakhstan, as a sovereign nation, to refrain from applying new law; the most one should reasonably hope for in this circumstance is an award of compensatory damages.

Note finally the Petroleum Law provision (Art. 2.4) that precedence shall be given to terms of treaties (to which Kazakhstan is a party) that differ from the Petroleum Law's own terms. To the same effect, see Constitution Art. 43, Civil Code Art. 3.8, and FIL Art. 3.4. There are no express stabilization provisions in any pertinent treaties of which we are aware (*e.g.*, the Energy Charter Treaty, or the Kazakhstan-United States Bilateral Investment Treaty).[24] However, the Energy Charter Treaty, which by and large concerns transportation issues, may work to effect some favorable departures for investors from Kazakh law now or in the future, to the extent that its substantive terms differ from those of national law. (As noted above, this treaty has already been ratified by Kazakhstan and thirty-nine other countries, and is in effect for those countries.) Other treaties may also be of help in this way in the future.

[24] The Energy Charter Treaty, at Article 10, merely directs in general terms that the Contracting Party States shall create "stable, equitable, favourable and transparent conditions for Investors," that Investments shall enjoy "the most constant protection and security . . . ," and that each Contracting Party shall "observe any obligations it has entered into." (Art. 10(1)) There is also a requirement to accord Investors most-favored-nation or national treatment, whichever is the most favorable. (Art. 10(3))