

Kazakhstan Subsoil Code: What's the Outcome?

Кодекс РК «О недрах и недропользовании» – что получилось

Olga Chentsova, Doctor of Law, Managing Partner
AEQUITAS Law Firm

Natalya Braynina, Partner AEQUITAS Law Firm

Yelena Manayenko, Senior Associate AEQUITAS Law Firm

Ольга Ченцова, управляющий партнёр юридической
фирмы «AEQUITAS», кандидат юридических наук

Наталья Брайнина, партнёр юридической фирмы
«AEQUITAS»

Елена Манаенко, старший юрист юридической фирмы
«AEQUITAS»

The legislation on subsoil and subsoil use of the independent Kazakhstan has been forming from the first days of the Republic proclamation, and has a storied history by now. Regulations at the level of laws and Presidential edicts were repeatedly interchanging, being complemented by subordinate legislative acts of different legal force.

On 27 December 2017, the President of Kazakhstan signed the Code of the Republic of Kazakhstan «On Subsoil and Subsoil Use.» The Code (after its Concept had been approved in summer 2015) came up as a result of more than two-year drafting work primarily performed by the tender-winning law firms and staff of the relevant ministries, discussions inside the business community, including public professional organizations, and at the final stage – the work of parliamentarians. So, now the subsoil and subsoil use in Kazakhstan are for the first time governed by the Code, an act of legal force even higher than that of the laws.

We have been watching the development of the Concept and the Code, participating in their discussion and putting forward our proposals (please see for example: N. Braynina. Subsoil Code: What Oil Industry Investors Should Expect? PETROLEUM magazine, No. 3, 2017). It must be mentioned that in the course of work both the Concept and the draft Code had

been changing, sometimes drastically. The subsoil users, same as investors and lawyers, are now interested to know – what is the outcome of the grand plot?

1. GENERAL CHARACTERISTICS OF THE CODE

1.1. Structure of the Code

The Code, as would be appropriate for the act of such level, contains the General and the Special parts. The General Part comprises 5 Sections (Articles 1–83) governing a broad range of general subsoil use issues and determining their basic legal regime. The Special Part of the Code also comprises 5 Sections (Articles 84–278) and it is much more voluminous than the General Part.

1.2. The General Part

Section 1 includes general provisions on the legislation governing subsoil use, its goals and objectives (on of which is creation of conditions for attracting investments into the geological study of subsoil and subsoil use). One of the principles is stability of subsoil use conditions. The Code keeps the important rule to vicariously apply civil legislation to relations in the area of subsoil use – it applies in cases unsettled by the Code regulations. The Code has no separate Article setting out the terms and definitions, which are now scattered throughout the text of Articles.

Section 2 contains general provisions regarding subsoil use right

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(including the concept and content of subsoil use right, holders of such right, bases for its origination and acquisition, etc.). The same section includes an Article about ensuring the local content. A separate Chapter is dedicated to the subsoil use right regimes – licensing and contractual. Certain chapters are dealing with the transfer of subsoil use right and the operator in the subsoil use area.

Section 3 is specifically dedicated to the safe use of subsoil, including requirements to safety in the course of subsoil use operations and cleanup.

Section 4 regulates state administration in the subsoil use area, including the system of governmental agencies, procedure for control over compliance with contracts and legislation, as well as the issues of state subsoil fund (including fund management, state geological study of subsoil, geological information, subsoil user's reporting, and provision of access to the information on subsoil use licenses and contracts).

And, finally, Section 5 of the Code very briefly addresses subsoil dispute resolution issues and the issues of liability and international cooperation in this area.

The dispute resolution provisions have been changing over the time of work on the Code. As a result, it was determined that disputes relating to the exercise, modification or termination of the subsoil use right are to be settled in accordance with the laws of the Republic and the international treaties ratified by Kazakhstan.

1.3. The Special Part

The Special Part includes sections dedicated to the geological study of subsoil, exploration and production of hydrocarbons, extraction of uranium and exploration and extraction of solid minerals. The last Section 10 is titled «The Use of Subsoil Space, Artisanal Mining, and Final and Transitional Provisions.»

1.4. Code Enactment and Transitional Provisions

The Code enactment procedure is regulated by Article 277. The Code is put into effect upon expiration of 6 months after the date of its first official publication on 5 January 2018, i.e. starting 6 July 2018. The exception is the rule governing a specific instance of including data in the state subsoil fund management program based on subsoil user's application, which has already been in force since 16 January 2018. Three rules of regulatory nature are to be put into effect in the years 2020 and 2021.

However, Article 277 primarily regulates not the Code enactment, but the issue of its application to relations under subsoil use permits, licenses and contracts issued and entered into prior to the Code's entry into effect. The Article establishes, as a general rule, that the Code applies to subsoil use relations arising after its enactment, except as provided for in Chapter 35 (Final and Transitional Provisions), but the number and the content of exceptions are such that it invites a conclusion that the general rule should have been worded exactly to the opposite.

Transitional provisions are set out in Article 278 of the Code, which also establishes a general rule pursuant to which subsoil use permits, licenses and contracts issued and entered into prior to the Code enactment, as well as all related acts of the executive authorities of the Republic of Kazakhstan, remain in effect, except for the cases provided for by the Code. Further, Article 278 sets forth the relevant exceptions, which also require most careful analysis.

1.5. Legal Writing of the Code

The worst impression comes from the Code's legal writing. An illustration can be Section 10 dealing with such diverse matters as the space of subsoil and artisanal mining (Chapters 33 and 34) and the final and transitional provisions (Chapter 35, comprising Articles 277 and 278).

Such solution is unlikely to find a logical explanation. But even more questionable are the two Articles – 277 and 278 – mentioned above, as important, as they are complex and at times incomprehensible. These Articles take up dozens of pages and contain hundreds of rules, which could have made at least a separate Section of the Code, both by their significance and by the scope of issues governed thereby. But the biggest, even a huge flaw of these Articles is their entanglement due to the lack of logical and understandable system of headings and absence of designated subject matters of regulation. As a result – a huge lot of time the lawyers and other interested persons will spend trying to figure out the essence of the regulations, and the possible errors in calculating the paragraphs and subparagraphs of the Articles that are unnumbered, yet referenced throughout the same Articles and the whole Code.

It is well known that a clear-cut and comprehensible legislation is of paramount importance not only for attracting investments, but also for preventing corruption. In this regard, Articles 277 and 278 are not just flawed, but, in our view, are badly tainting the image of the country



purporting to attract investments into subsoil use.

1.6. Important Developments in the Subsoil Use Legal Regime

The conceptual changes in the legal regime of subsoil use (of which the key change is the replacement of the contract system by the licensing system) have primarily affected the mining industry. Licenses will be issued for the exploration and extraction of solid minerals, and the subsoil space will be used, and artisanal mining will be carried out, on the basis of licenses.

As to the legal regime of hydrocarbons, the developments are not as radical as in the mining industry. However, some of the changes are of major importance. We are expanding in detail on the specifics of hydrocarbons and hydrocarbons-related legal regulation in section 2 hereof.

Other important provisions of the Code are those addressing the geological study of subsoil and regulation over subsoil use stabilization matters.

The geological study of subsoil will be carried out on the basis of a license as well, the licensee to be entitled to use subsoil for three years in order to conduct geological survey and/or geophysical operations, as well as underground water prospecting and evaluation work. The license for the geological study of subsoil does not grant its holder an exclusive right to a geological study block, unless an RK Government resolution establishes otherwise. The licensee may freely use the geological information obtained by him in the course of the geological study. However, he must transfer such information to the authorized agency within one month of the license expiration date, and the authorized agency may disclose such information upon expiration

of 5 years of the date of its receipt (confidentiality period).

Subsoil Use Stabilization Regime. For the first time in the history of the Kazakh legislation governing subsoil use contracts relating to hydrocarbons, the key legislative act is missing a separate article establishing subsoil user right guarantees. This provision is «hidden» in Article 36 «Contents of Subsoil Use Contracts.»

Instead of the expanded scope of stabilization guarantee coverage, as expected and as provided for in the Draft Code, the subsoil users have faced a narrowing of the guarantee coverage.

The guarantees established by the Code (same as by the still effective Subsoil Law) provide that only legislative amendments deteriorating the results of subsoil user's entrepreneurial activities will not apply to subsoil contracts. Pursuant to the Code, this guarantee fails to cover not only legislative amendments in the area of national security, defense capacity, environmental safety, healthcare, taxation and customs regulation (as in effect at present), but also those in the area of competition protection.

As regards the temporal scope of the new «grandfathering clause,» the stabilization guarantee does not apply to contracts executed before the Code's entry into force (as suggested by Article 277 of the Code regulating its enactment procedure). That is, ideally, the «curtailed» guarantee should apply only to contracts entered into under the new Code (unless, of course, when introducing some necessary amendments into the old contract, the subsoil user also agrees to concurrently change the relevant contract provisions to the new ones).

When determining the scope and content of the guarantees applicable to the «old» contracts, taken into account should be the time of



conclusion and the content of such contracts.

2. KEY CODE PROVISIONS GOVERNING SUBSOIL USE IN THE HYDROCARBONS AREA

The legal regulation over subsoil use in petroleum industry has undergone no radical changes. At the same time, the Code has set some new rules for petroleum operations, which may apply, among others, to the new subsoil contracts to be executed in the future after the Code enters into effect, and to the currently effective subsoil contracts.

2.1. Classification of Hydrocarbons and Deposits

Unlike the legislation previously in effect, the Code provides for a detailed classification of minerals, including hydrocarbons. For instance, hydrocarbons mean crude oil, gas condensate, gas (including crude natural and associated gas and gas from low permeability (shale or coal) reservoirs) and natural bitumen. The Code gives definition for each type of hydrocarbons.

As to the classification of deposits, indicated as a separate category are large mineral deposits with a certain quantity of in-place reserves set as a criterion. Recognized as large hydrocarbon fields are those containing more than 100 million tons of oil or more than 50 billion cubic meters of natural gas.

2.2. Granting of Subsoil Use Right

Contract and licensing regimes. As regards hydrocarbons, subsoil use right is granted to conduct the following operations: 1) geological study of subsoil; 2) mineral exploration; 3) mineral production; 4) use of subsoil space for the purposes unrelated to the mineral exploration and/or production.

Pursuant to the Code, exploration and production of hydrocar-

bons are conducted based on subsoil use contracts.

Geological study of subsoil is implemented based on a license. Where a subsoil user needs to deploy and operate underground oil and gas (or oil or gas products) storage facilities or underground structures associated with the disposal of waste and toxic substances, or where it is necessary to inject water into subsoil to artificially recharge groundwater, the subsoil user must also obtain the appropriate license.

Procedure for Obtaining the Right to Exploration and Production. As a general rule, contracts for the exploration and production or for production of hydrocarbons will be concluded based on the results of an auction (unlike the tender requirement in effect before the Code enactment). Contracts with the national company will be concluded both in accordance with the general procedure and based on the results of direct negotiations. The potential subsoil user must meet the following requirements:

1). Not to be in the process of dissolution (for legal entities), reorganization (for legal entities), or bankruptcy;

2). Not to have outstanding arrears on taxes and other mandatory payments to the state budget;

3). In case of applying for subsoil use rights to hydrocarbons exploration and production – to possess financial resources sufficient to fulfill the minimum requirements to the volumes and types of work at the subsoil block during the exploration period;

4). In case of applying for subsoil use rights at an offshore subsoil block – to possess a positive experience of conducting subsoil use operations in the territory of Kazakhstan's continental shelf, in Kazakhstan's inland water bodies, or offshore outside the Kazakhstan

territory. This condition is deemed to be satisfied if such positive experience is possessed by a person holding at least 25% of shares (participation interests) in the subsoil user.

The potential subsoil user must submit the application for auction to the competent authority, attaching the required documents the list of which is determined by the Code. The application is to be in respect of a certain block of subsoil, which is included in the state subsoil fund management program as a territory where the right to use subsoil is granted via an auction. The competent authority is to consider the application within 20 business days and resolve to conduct the auction or refuse to consider the application.

Once it has resolved to conduct the auction, the competent authority publishes in mass media the relevant notification, after which other potential subsoil users interested in obtaining the subsoil use right in respect of that subsoil block may submit to the competent authority the application for participation in the auction.

The grounds on which the competent authority may refuse to accept for consideration the application for auction or refuse to accept the application for participation in the announced auction, include, among other, the following: (1) the subsoil use contract with the applicant or the person directly or indirectly controlled by or controlling the applicant was terminated on the initiative of the competent authority within 3 years prior to the application submission date; (2) the applicant has non-eliminated breaches of contractual obligations under another subsoil use contract; and (3) the grant of subsoil use right to the applicant may result in a threat to the country's national security, including through concentration of subsoil use rights.

The auction is conducted by a special commission approved by the competent authority and being a standing collective body. The participant proposing the largest signature bonus is declared the auction winner.

2.3. Project Documents

The Code contains a separate detailed Chapter 19 titled «Project Documents in the Area of Subsoil Use Relating to Hydrocarbons.» Pursuant to this Chapter, at all stages of a hydrocarbons field development the subsoil user must prepare and have approved both basic project documents (which include the exploration project, test operation project and hydrocarbons field development project) and technical project documents, the list of which is established by the unified rules

for the rational and integrated use of subsoil.

2.4. Subsoil Use Contracts

Types of contracts. The contract is concluded in order to conduct exploration and production or production of hydrocarbons. The Code provides for no possibility to conclude contracts only for exploration.

The Code does not expressly define which type of civil law contracts a subsoil use contract refers to and does not provide for the possibility to enter into globally adopted contracts, for instance, in the form of production sharing agreements.

Compliance with the model contract. Subsoil use contracts are drafted in accordance with the model contract for the exploration and production or production of hydrocarbons approved by the competent authority. Deviation from the model contract is allowed in cases, to the extent, and in accordance with the procedure stipulated by the Code. Analysis of the Code shows that actually no such cases are provided for.

Terms and conditions of a subsoil use contract. The Code contains mandatory provisions to be set out in a subsoil use contract. Generally, the content of subsoil use contracts under the Code is practically the same as that under the Subsoil Law. However, unlike the Law, the Code requires no provisions on the signature bonus amount and payment procedure, as well as on associated gas processing (utilization), to be included in the subsoil use contract.

Changing the contract conditions. The Code sets forth a limited list of grounds based on which the contract may be amended by way of executing a supplementary (amendment) agreement. Such amendments relate to the information on subsoil user, extension of exploration and/or production periods, transfer of the rights under the contract, or changes in the contract area.

In case of changing (extending) the subsoil use contract's term, the subsoil user is to enter into a new contract according to the terms and conditions of the model contract, if the original contract was entered into prior to the Code enactment and does not conform to the model contract.

Moreover, if the original term of a production contract was 20 or more years, in case of its extension the competent authority and the subsoil user are to enter into a new production contract drafted in accordance with the model contract.

Thus, the Code has a built-in mechanism to bring all oil contracts, including those previously concluded, in line with the model contract, and in case of extending contracts with a 20+ year production period



this may also entail changes in the entire contract regime (according to the legislation in effect at the time of such extension).

2.5. Exploration and Production Periods and Field Facilities Construction

The effective term of a hydrocarbons exploration and production contract is determined by the subsoil block (blocks) usage periods. The term of an exploration and production contract comprises the period of exploration, preparatory stage (if necessary) and period of production, subject to possible extensions. The term of a production contract consists of the preparatory stage and production period.

Exploration period. The period of exploration is calculated from the date of registration of the hydrocarbons exploration and production contract. The period of exploration is 6 years, and in case of offshore operations or complex hydrocarbons exploration projects – up to 9 years. Complex hydrocarbons exploration projects mean projects under hydrocarbons exploration and production contracts, which involve drilling of wells 6,000 or more meters deep.

In case a hydrocarbons reserve is discovered, in order to conduct its evaluation and test operation the period of exploration may be extended by up to 3 years and in respect of offshore operations or complex exploration projects – for a period of up to 6 years. However, the extension is possible only within the area of occurrence of the probable reservoir.

In order to conduct test operation of a discovered reservoir, the period of exploration may be further extended by up to 3 years, and at offshore blocks or for complex hydrocarbons exploration projects – by up to 6 years. And in order to conduct test operation of a sec-

tion comprised of the blocks within which the hydrocarbons reservoir(s) is located, the exploration period may be further extended one time by up to 3 years, accordingly reducing the maximum period of production and provided that the positive opinions of governmental agencies are in place.

Thus, subject to such extensions, the maximum period of exploration will make 12 years, and for offshore blocks or complex projects – 18 years.

Production period. According to the Code, the period of hydrocarbons production cannot exceed 25 years, or 45 years for large or unique fields. However, systems interpretation of the Code regulations invites a conclusion that it is allowable to extend the production period for 25 consecutive years, provided that the subsoil user timely applies therefor. Vague language of Articles 119 and 120 of the Code describing the periods of production and the possibility to extend them might yield another interpretation of these provisions, where the maximum production period cannot exceed, subject to extensions, 25 and 45 years accordingly.

The Code establishes additional requirements providing for the possibility to extend contracts for large unique fields. In case a subsoil contract's term is extended by more than 10 years at such fields, the contract provisions must be supplemented by one of the following additional obligations determined by the Code, which include: (1) setting up processing plants independently through organizing a new legal entity, or jointly with other persons; (2) modernization or reconstruction of the existing production or processing plants; (3) sale of the produced mineral for processing to Kazakhstan processing plants on contractual terms; (4) implementation of another investment project



or a project aimed at the socio-economic development of the region, independently through organizing a new legal entity, or jointly with other persons.

Field Facilities Construction. Pursuant to the Code, «field facilities construction» means construction of field and other facilities necessary for the production, preparation, storage and transportation of hydrocarbons from the place of production and storage to the place of transshipment to the main pipeline or other type of transport.

The Code explicitly sets forth that construction of facilities at a discovered field is to be carried out during the preparatory stage, after the exploration period is completed and until the production period is fixed. The duration of the preparatory stage cannot be more than 3 years, accordingly reducing the maximum duration of the initially established period of production.

2.6. Gas Flaring

Flaring of crude gas is prohibited, except for the following cases: (i) a threat or arising of emergency situations, threat to the life of personnel or public health, or to the environment; (ii) well facilities testing; (iii) field test operation; and (iv) technologically inevitable flaring of crude gas. However, except for emergency situations, flaring is permitted only if the appropriate consent of the authorized agency in the area of hydrocarbons is in place.

The Code clarifies the definition of «technologically inevitable gas flaring» that covers «flaring of crude gas in order to ensure uninterrupted process of hydrocarbons production during commissioning and adjustment, operation, maintenance and repair of process equipment...» The current Subsoil Law contains a very restricted definition stating that technologically inevitable gas

flaring is permitted only where gas processing (utilization) is technically impossible.

Except for the instances where the Code permits crude gas flaring, as well as in cases where the subsoil user uses crude gas for its own technical needs or sells it to a third party, production of hydrocarbons without processing the entire volume of crude gas is prohibited.

2.7. Local Content

The Code generally preserves the legal regime of supporting local producers in terms of local content in personnel, procured goods, work and services. For instance, the Code expressly obligates subsoil users to ensure that local content in work and services procured in the framework of subsoil use operations constitutes at least 50% of the total volume of work and services procured over a calendar year. Preference must also be given to local personnel in subsoil use operations.

At the same time, the allowable percentage of foreign employees engaged via intra-corporate transfer has increased from 25% to 50%.

The Code does not set a definite percentage of local content in goods, saying that such percentage is to be determined by the subsoil user in accordance with the unified local content calculation methodology approved by the authorized agency in the area of state support of industrial-and-innovation activities.

2.8. Subsoil User Reporting

The Code provides for 7 different principal reports the subsoil user will be to regularly submit to the authorized state agencies, one of which is the report about the persons and/or organizations directly or indirectly controlling the subsoil user. The Code obligates the subsoil user to notify the competent authority about changes in the composition of the persons and/or organizations

directly or indirectly controlling the subsoil user within 30 days of the date of such changes. The control is defined as holding more than 25% of votes, or rights to income from the subsoil user's activities, or rights to adopt decisions in respect of the subsoil user.

2.9. Transfer of Subsoil Use Rights and Alienation of Subsoil Use Right-Related Objects; State's Preemptive Right

Transfer of subsoil use rights and alienation of subsoil use right-related objects. The transfer of subsoil use right (a part thereof) and subsoil use right-related objects (as per the current terminology – transfer of subsoil use rights) will be performed, same as today, on consent of the competent authority to be issued in accordance with the established procedure.

The Code expands the definition of «subsoil use right-related objects,» which now include, beside the previously statutorily defined participation interests (shareholdings) and securities convertible into shares in a legal entity holding a subsoil use right, or in a legal entity or other organization having the possibility to directly and/or indirectly determine the decisions made by the subsoil user. Both the Subsoil Law and the Code do not recognize as subsoil use right-related objects the shares, participation interests, units and other instruments of shared participation in legal entities and organizations holding subsoil use right-related objects, which are traded on an organized securities market.

The Code provides for a broader range of exceptions from the general rule requiring the competent authority's consent to the transfer of subsoil use rights and subsoil use right-related objects than those envisaged by the legislation currently in effect.

State's preemptive right. The state has a preemptive right over third parties to acquire the alienated subsoil use right or such subsoil use right-related objects in respect of the fields/deposits of strategic significance. As regards hydrocarbons fields, recognized as strategic is a subsoil block, which (i) contains more than 50 million tons of in-place oil reserves or more than 15 billion cubic meters of in-place natural gas reserves, or (ii) is located in the Kazakhstan sector of the Caspian Sea.

The Code also says that the list of fields/deposits of strategic importance is approved by the Government of the Republic of Kazakhstan. Therefore, in order for a field to be recognized as having strategic importance, it must satisfy two con-

ditions: meet the above criteria and be included in the list approved by the Government of the Republic.

The Code grants exemptions for certain transactions, which would not require the state's waiver of its preemptive right, including: (1) transactions in respect of securities traded on an organized securities market; (2) transfer of subsoil use rights or subsoil use right-related objects between legal entities each of which is 99 or more percent owned by one and the same person; (3) direct or indirect transfer of less than 1% of shares (participation interests) in the subsoil user's charter capital; and (4) changes in the amount of the charter capital of the subsoil user (or a person controlling it, directly or indirectly), if such change does not affect the percentage ratio of interests.

2.10. Early Termination of Contracts on Competent Authority's Initiative

The Code expands the list of grounds for early termination of the contract on competent authority's initiative. In addition to the currently existing grounds, the Code entitles the competent authority to early terminate the contract in case: (1) a court decision prohibiting subsoil use activities comes into force; (2) subsoil use operations relating to hydrocarbons are conducted without appropriate project documents approved by the subsoil user and having received positive expert opinions envisaged by the Code; and (3) the earth surface integrity is damaged in the course of subsoil use without provision of financial security for the cleanup operations or in breach of the security provision schedule.

The competent authority notifies the subsoil user in writing about committed violations, demanding in certain cases not just to eliminate the committed violation, but also to pay the relevant penalty (liquidated damages).

When resolving to early terminate the contract, the competent authority also makes one of the following decisions: (1) to clean up the consequences of subsoil use operations; (2) to conserve the subsoil use facility until it is transferred to a third party; or (3) to transfer the subsoil block to the national company for trust management until it is transferred to a third party.

2.11. Exploration and Production Cleanup

The Code regulates anew the issues of subsoil use cleanup. The consequences of exploration and production are to be cleaned up as before in accordance with the abandonment plan, while security

to ensure performance of subsoil user's obligations to clean up the consequences of hydrocarbons exploration and production is to be provided exclusively in the form of a pledged bank deposit, except for offshore hydrocarbons exploration operations.

The bank deposit is formed in full based on the exploration project documents determining the market value of cleanup operations. The amount of bank deposit may be increased in

case of the relevant changes in the project documents. When transferring the subsoil use right, the subsoil user's rights to the pledged bank deposit transfer, on a mandatory basis, to the new subsoil user.

For contracts entered into before the Code enactment, the provisions of the Subsoil Law governing the formation and use of the abandonment fund will remain in effect for 36 months after the date of the Code's entry into force. ■

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