



# LEGAL BASE OF THE OIL AND GAS INDUSTRY

**Aequitas Legal Firm**  
(Specially for Oil&Gas Vertical)

Over the last several years our Company has provided annual overviews of legal regulation of Kazakhstan's oil and gas industry for the October issues of the Oil & Gas Vertical published for KIOGE. Traditionally we focus on major legislation components constituting a legal base of the oil and gas industry, like investment, subsoil use, oil marketing and transportation, and environmental protection. We do not address taxation here because that important issue calls for a separate discussion.

It should be noted that the relations in the oil and gas industry, like any other market relations are impacted by multiple provisions of the civil, banking, corporate, currency, land, and other laws governing specific economic sectors. Also, provisions of the administrative and criminal law should be taken into account for a complete picture of a legal regime governing the oil and gas industry in Kazakhstan.

We will focus our discussion of the applicable oil and gas legislation on the critical changes approved since the publication of the previous overview (Oil & Gas Vertical, #17, 2007)

## INVESTMENT LAW

The main source of foreign investment regulation is the national law and international treaties, including bilateral investment protection agreements involving Kazakhstan.

The major trend registered in the changing investment legislation is phasing out privileges to foreign investors, granting them equal rights with domestic investors, and in some cases even worsening the position of foreign investors compared to their local counterparts.

The Law On Foreign Investment effective from 1994 to 2003 provided for a number of special guarantees to foreign investors and granted them certain privileges compared to domestic investors. The 1994 Law played a positive role in attracting foreign investment and creating a stable investment regime for them. However, in

The legal base of Kazakhstan's oil and gas industry includes the following key components: the investment, subsoil use, oil and product marketing and transportation, environmental protection, and tax law. The national legislation continues to improve. Last year, significant amendments were made to the civil law and the subsoil use law. Other Kazakhstan's laws, including the investment and environmental protection laws have been amended as well.

Talking about the direction of change in the "rules of the game" for the companies operating in the national oil and gas sector it should be admitted that the national law denies foreign investors any privileges and even in some cases puts them in a more difficult situation compared to local companies. The government is strengthening direct control of the industry projects, among other things, through broadening the powers of the National Company. The Kazakh content and environmental protection requirements are getting increasingly stringent.

2003, it was replaced by a new Law On Investment (hereinafter, the Law or the 2003 Law), which cancelled all privileges to foreign investors. As opposed to the 1994 Law, the Law did not make any distinction between the domestic and foreign investors. Hence, the provisions of the new Law are equally applicable to foreign and domestic investors and investment.

Since in the previous overview we have discussed the 2003 Law in detail, and the last year saw no significant changes to that Law, we will limit this discussion to the key provisions of the investment law. We would like to remind the readers that the 2003 Law included agreement stability provisions, revenue disposal guarantees, and guarantees against nationalization and requisition, as well as the right to international arbitration. The said guarantees, however, were provided either in the form of fairly general statements or by reference to other laws containing such guarantees in some form or other.

The stability provisions in the 2003 Law apply only to the agreements concluded between the investor and the government body. Even in that case, the stability principle does not apply when it comes to amendments and additions to the laws of Kazakhstan made in the interests of national security, environmental safety, public health, and morale. Amendments to the Kazakh law or new international agreements changing the procedure and conditions of imports, production, and sales of goods subject to excise tax are not subject to stability provisions either.

The 2003 Law does not allow resolution of disputes through arbitration without the Government consent, and allows investment dispute resolution through international arbitration only to the extent such dispute resolution is stipulated by Kazakhstan's international treaties or by earlier arbitration agreements.

The Law contains an obscure provision to the effect that the disputes other than investment disputes shall be resolved in compliance with the law of Kazakhstan. We believe that the said provision should be interpreted as confirmation of the investors' right to bring disputes to arbitration because that right is generally recognized by Kazakhstan's civil law.

The Law grants the right to unrestricted disposal of revenue generated from the investment activity, but unfortunately provides no guarantee for unrestricted transfer of the investor's own currency funds stipulated in the 1994 Law. The absence of the said guarantee in the Law should be offset by appropriate international agreement provisions (if applicable).

The 2003 Law contains a number of tax and other allowances for investors in priority economic sectors listed by the Government. Subsoil use operations fail to be included in that list. However, some oil and gas operations may be categorized as priority operations, but the investor may be granted some privileges only on the basis of a contract concluded with the authorized government body responsible for investments.

## SUBSOIL USE LAW

### General Description

Subsoil use for the purpose of oil and gas operations is regulated by the national law comprising legal acts of different legal force. First, the constitutional base of Kazakhstan's oil and gas business, specifically, the property provisions of the 1995 Kazakh Constitution should be taken into account. The basic law is the 1996 Law On Subsoil governing subsoil use issues applicable to all minerals, and the 1995 Law On Oil applicable exclusively to oil and gas. Both Laws have been subject to multiple amendments and additions. Most significant changes were made in 1999, and then the Laws were changed twice in December 2004. The latest changes in the said Laws were made in December 2006, then in January and October 2007.

In 2005, the Law On Production Sharing Agreements (Contracts) for Offshore Oil Operations was approved. The Government is presently contemplating elimination of production sharing agreements, and rescinding the PSA Law.

In addition to the Laws On Subsoil and On Oil, a number of follow-up legal acts are in effect in Kazakhstan governing general oil and gas business issues, as well as special subsoil use issues. For instance, in 2007 and 2008, a number of follow-up legal acts have been approved in Kazakhstan. These are:

- The Kazakh Government Decree Approving the Rules for Subsoil Use Asset Abandonment and Conservation (January 2008);
- The Kazakh Government Decree Approving the Rules for Subsoil Users' Reporting on Subsoil Use Operations (July 2008);
- Order Approving the Format of Subsoil Users' Reports on Goods, Works, and Services Purchased and the Next Year Procurement Outlook (March 2007);
- Order Approving the Requirements to the Content and Scope of Geological and Geophysical Data Supporting the Estimate of Oil, Gas, Condensate, and Associated Component Reserves to be

Submitted to the State Expert Review (May 2007).

One of the major subsoil use related international agreements ratified by Kazakhstan is the Agreement to the Energy Charter. Also important are bilateral investment protection agreements concluded by Kazakhstan. Kazakhstan has presently ratified 40 agreements for mutual protection and support of investments (capital investments). Specifically, in 2008, such agreements were ratified with Finland and the Jordan Hashemite Kingdom.

### Legislation Development Trends and Outlook

**Trends.** The main legislation development trend registered over the last several years is towards a closer Government control in strategic economic sectors, including subsoil use. The Government is also imposing a tighter control over the companies supporting the resource development business. Hence, the current trend should be described as permitted Government interference in economic operations conducted by subsoil using companies and their subcontractors.

The most recent example confirming the said development towards a closer Government control in strategic economic sectors is the amendments to the Civil Code of Kazakhstan approved in August 2007, as well as the Laws On Limited Liability Partnerships and Joint Stock Companies, and the Law On National Security. All the amendments were aimed at securing national interests in the economic sphere.

Now it has been legally established that the property of social and economic value influencing a stable development of Kazakhstan's economy the ownership and (or) use of which would impact the condition of Kazakhstan's national security shall be categorized as strategic assets. Strategic assets may include assets directly or indirectly related to oil and gas operations, like main oil and gas pipelines or seaports of international importance.

Granting rights to such assets to third-parties or their alienation may be allowed based on the Government decision for granting an appropriate permit, and under the Government established procedure. It has also been established that the Government shall have preemptive right to buying such assets at a market price should the owner of such assets decide to sell.

In 2008, a number of follow-up legal acts have been approved governing individual issues of encumbrance and alienation of strategic assets; the use of the Government's preemptive right for buying a strategic asset in case of its



alienation. Also, lists of strategic assets were approved, which specifically include some gas and oil pipelines. The approved follow-up legal acts, among other things, contain the following:

- Lists of strategic assets contributed to the charter capital and (or) in the ownership of national holding companies and (or) national companies or their affiliated entities, as well as other legal entities with government ownership, as well as strategic assets owned by legal entities which are not affiliated with the Government, and by physical persons;

- Rules for strategic asset alienation and encumbrance with third party rights;
- Rules for the use of preemptive rights to buying a strategic asset.

The amendment to the Law On Subsoil made in October 2007 establishes that a subsoil area (field) could be attributed to strategic assets subject to a special legal regime, which will be described below in the Government Preemptive Right section.

The Government is committed to the development of the domestic market and supporting Kazakhstan's manufacturers, which has been reflected in the subsoil use legislation. Over the last several years, much attention has been given to environmental protection regulation, and the legislation has clearly acquired a greater environmental focus. Kazakhstan's environmental legislation is continuously changing, which cannot but impact the general subsoil use legal base. These issues will be addressed at a greater detail in the last section of this overview.

The development of Kazakhstan's laws on technical regulation should also be noted because legal regulations governing the national oil and support industries are aligned with the provisions of the said laws. Kazakhstan is presently preparing to join the World Trade Organization (WTO), and the process of aligning its legislation with the standards of that organization is under way, which, in turn, dictates the need for introducing a number of norms and rules impacting subsoil users.

**Outlook.** The major and most important change in the subsoil use and oil laws is the anticipated approval of the new Kazakh Law On Subsoil and Subsoil Use in Kazakhstan (hereinafter, Draft or Law), which will invalidate earlier Laws On Subsoil, On Oil, and On PSAs. The relations associated with oil operations will apparently be regulated by a single Law.

The Draft contains multiple innovations, including critical provisions impacting the currently applicable general subsoil use regime. For instance, the Draft provides for granting separate rather than combined exploration and production licenses; the exploration

period is limited to 6 years without extension; weaker contract stability guarantees (specifically, it is established that the contractual tax regime may remain intact only if approved by a special Law of the Republic of Kazakhstan).

The Draft stipulates a detailed procedure for assigning subsoil use rights (the corresponding regulations have been significantly changed), and contains detailed provisions for the Government preemptive right to buying subsoil use rights, interests (stocks) held by subsoil using legal entities and entities controlled thereby in case of alienation of the said rights and interests. The Draft exempts IPO-related transactions and exchange deals from the above provisions.

The Draft addresses the issues of drafting project design documentation. It establishes a more reasonable schedule for approving such documentations and conducting preparatory work for project operations startup. A detailed procedure has been established for contract execution, and a certain effort has been made to standardize the terminology. Criteria for identifying winners in subsoil use tenders have been changed. The Draft contains more stringent provisions for contract termination by the initiative of a competent government body, etc.

We would refrain from a more detailed description and comment on the document given that it is only a draft still in development which has not been submitted to Parliament as yet. We believe that the Draft may undergo multiple and significant changes prior to its approval into Law.

### Industry Specifics

The basic terms used in the Law On Oil and the Law On Subsoil: "Oil Operations" and "Subsoil Use Operations" are different in scope. Therefore, some relations are governed by only one of the said Laws. The Law On Oil expressly stipulates that in the case of a discrepancy between the Law On Oil and the Law On Subsoil with respect to work covered by the term "Oil Operations" the Law On Oil controls.

The PSA Law presently has limited application. The said Law governs only one type of contracts and only for offshore operations. It should be expected that new production sharing agreements with investors would be banned in the near future. Prior to 1999, a licensing/contract system was effective in Kazakhstan under which the basis for execution of an oil and gas exploration and/or development contract was an appropriate license granted to the investor. Since 1999, Kazakhstan has been using a contract system for

granting subsoil use rights and the rights to conduct oil operations under which the subsoil user (contractor) obtains the said rights by concluding a contract with an authorized government body acting on behalf of the State (competent body). However, the licenses granted prior to the termination of the licensing procedure remain in effect and are subject to the law effective as of the date of the license granting.

The right to operate oil pipelines arises from a license granted by a government body controlling and regulating natural monopolies.

The parties to a subsoil use contract are the competent government body and the subsoil user. Pursuant to the Law On Oil, the competent government body is defined as a government body designated by the Kazakh Government and acting on behalf of the Republic of Kazakhstan in exercising the rights associated with the government regulation of oil operations, execution, and implementation of appropriate contracts. As of 2004, the powers and responsibilities of the licensing body (the Government of Kazakhstan) with respect to earlier issued licenses have been vested in the competent body. Today it is the Ministry of Energy and Mineral Resources of Kazakhstan.

In addition to the authority to enter into contracts, the said Ministry has a number of oil and gas industry regulation and control powers. The powers and responsibilities of the Ministry are defined by the Laws On Oil and On Subsoil, and by the Ministry Charter.

The other party to the contract (subsoil user or contractor) may be the Kazakh and foreign legal entities, as well as physical persons enjoying equal rights.

**Other Contract Parties.** Other parties to the subsoil use contract in the oil and gas sector could be the operator; under PSAs, the operator and the authorized body.

### The National Company

The National Company (AO NK KazMunaiGaz established by Presidential Decree in February 2002) still has a special role in the system of subsoil use relationship in the oil and gas sphere. The National Company is presently understood as "a joint stock company established by decision of the Kazakh Government the only shareholder of which is the national holding company conducting oil operations in compliance with the Law On Oil".

The shareholder of the National Company KazMunaiGaz is a joint stock company named Samruk, Kazakhstan's Holding Company for Managing Government Assets (hereinafter, the

Samruk Holding) with 100% government ownership. The Samruk Holding was established in 2006. Its only shareholder is the State represented by the Government of Kazakhstan.

The powers and responsibilities of the National Company are generally defined by the Law On Oil. The most important of them are:

- To represent the Government in projects executed under contracts with the National Company ownership under the procedure established by the Kazakh Government and within the authority stipulated in the contracts;
- To conduct oil operations jointly with the tender winners through acquiring participating interests in contracts by decision of the Kazakh Government;
- To conduct oil operations in the blocks granted for use through direct negotiations;
- To participate in the organization of tenders for oil operations on the territory of Kazakhstan, including the Caspian and Aral Sea sectors;
- To participate in Kazakhstan's domestic and international oil and gas and hydrocarbon transportation projects under the procedure established by the Kazakh law;
- To exercise corporate management and monitoring of hydrocarbon exploration, development, production, processing, marketing, and transportation, as well as oil and gas pipeline and oil and gas production facility design, construction, and operation;
- To take contract area under its control in case of termination of a contract for exploration, production, or a combined contract for exploration and production with imprudent contractor by the competent government body.

The National Company has the right to join oil contracts under the procedure established by the Government. The above means that the National Company may join a contract in certain circumstances, but is not obligated to do so.

The PSA Law regulates the matter somewhat differently granting the National Company the right to act as a contractor with 50% interest in all production sharing projects.

#### **How to Become Subsoil User**

The general rule is that the right to oil and gas exploration and development is granted based on the results of an investment program tender (either open or closed) through signing an agreement with the winner.

The right to oil and gas exploration and/or development is granted through direct negotiations only in the cases





established by law which we discuss in detail in our last-year overview.

The procedure for announcing and holding the tender, identification of the winner and other issues related to the procedure for granting oil and gas exploration and development rights are governed by fairly detailed legal provisions. Specifically, a broad list of terms and conditions has been established subject to obligatory inclusion in a tender proposal (commitments and intents with respect to environmental protection, regional and economic development, the Kazakh content, etc.).

Notably, the subsoil legislation amended in 2007 enables the competent government body to deny potential bidders the right to bid if the subcontract granted to such a bidder entails noncompliance with the national requirements, which may be under concentration of rights under one contract and (or) the rights for conducting subsoil operations.

#### **The Kazakh Content**

Over many years, Kazakhstan has been taking increasingly tough measures aimed at increasing the "Kazakh content", i.e. the involvement of Kazakhstan's personnel and the works and services of Kazakh manufacturers in oil operations.

All amendments to the oil and gas use legislation contained a number of provisions changing the regulatory regime on those issues one way or another. As a result of all those changes, a fair and legal regime has been established aimed at maximizing the use of local goods, works, and services by subsoil users as well as reducing the number of foreign personnel in the oil and support industries and services through tendering and hiring local personnel.

The currently applicable law obligates the subsoil user and his subcontractor to buy goods, works, and services from Kazakhstan's manufacturers, primarily through tenders. Subsoil users must tender within Kazakhstan. The tender organizer is required by law to give a 20% allowance to local bidders for the goods, works, and services if they meet the tender requirements under the Kazakh laws on technical regulations.

In staffing the project, the tender organizer is obligated to give preference to the Kazakh personnel. The subsoil use tender bid must include obligations with respect to hiring local personnel and proposals for financial programs, as well as the intent to increase the percentage of the total personnel used in the project.

The Kazakh law requires that the contract contain provisions penalizing the subsoil user for failure to comply with his local content obligations.

### **Subsoil Use Right Transfer and Assignment**

The January 2007 amendments to the Laws On Oil and On Subsoil established an even more rigorous procedure for the transfer and assignment of subsoil use rights. The law stipulates a general rule under which partial or full transfer of the subsoil use right by subsoil user to a third party, including the use of the said right as pledge shall be allowed only with the competent body permit. The said permit must be issued or reasonably withheld by the competent body within 45 days of appropriate request submission.

The Law On Oil provides for an exception from the above general rule: the right to offshore pipeline construction and operation cannot be transferred or assigned to any third party. No permit is required for subsoil use right transfer in the case of normal legal succession (for instance, as a result of merger, takeover, restructuring of a legal entity). One more restriction has been added to the subsoil use right transfer procedure. Now the said right cannot be transferred or assigned within two years of the contract effective date except for the case of legal entity liquidation, levy of execution upon the subsoil right used as pledge, or transfers resulting from legal succession or legal entity reorganization. The said restriction does not apply to subsoil right acquisition by the National Company or its subsidiaries.

Article 31 of the Law On Subsoil grants preemptive right to the Government for buying the subsoil right (or a portion thereof) and (or) participating interest in a legal entity holding the subsoil use right in case of its alienation on conditions that should not be worse than those offered by other buyers. To this date, no clear enforcement regulation has been established for Article 71 of the Law On Subsoil (the issue has been addressed in detail by the new Bill On Subsoil and Subsoil Use in the Republic of Kazakhstan).

### **Fields of Strategic Value**

The amendments to the subsoil use laws made in October 2007 granted the Kazakh Government the right to approve lists of subsoil areas (fields) of strategic value. A special legal regime is established for such subsoil areas (fields). Now the law provides that if the

actions of the subsoil user in the areas (fields) of strategic value materially impact economic interests of the Republic of Kazakhstan causing potential damage to national security, the competent body is entitled to request amendments and (or) additions to the contract in order to restore Kazakhstan's economic interests. In that situation, the competent body may unilaterally terminate the contract if:

- within two months of the receipt of an appropriate notice from the competent body of a proposed amendment and (or) addition to the contract the subsoil user fails to provide his written consent to conduct such negotiations or denies the request for such negotiations;
- within four months of the date of receipt of the said consent by the competent body from the subsoil user the parties fail to reach an agreement on the proposed amendment and (or) addition to the contract;
- within six months of the date of mutual agreement for restoring economic interests of the Republic of Kazakhstan the parties fail to execute the amendments and (or) additions to the contract (Article 45-2 of the Law On Subsoil).

The approved amendments invite a number of questions regarding their enforcement. For instance, it remains unclear on what basis one subsoil area or another is attributed to strategic assets. It could be reasonably assumed that major hydrocarbon, precious or rare-earth metal fields the development of which brings a significant share of the national budget revenue in the form of tax and obligatory payments by the subsoil user or a significant production share under PSA projects would be recognized as strategic assets in the subsoil use sphere.

In addition, under the currently applicable law there can be no guarantee that the list of strategic assets initially approved by the Government will not be subject to amendments and additions depending on the project economics or specific economic situation in the country.

The lawmakers provided no criteria for identifying a "significant impact on the national economic interests causing potential damage to national security" in the subsoil use sphere which constitutes the basis for unilateral contract termination. The provision for unilateral contract termination by the Government (Article 45-2 of the Law On Subsoil) causes serious concern to investors because a vague reference to a "potential damage to national security" gives the Government broad powers for unilateral termination of the contract without arbitration.

It is also unclear how the subsoil user's actions taken in compliance with the approved contract may "significantly impact national economic interests and cause potential damage to national security" of Kazakhstan. If the subsoil user is in compliance with the contract terms his actions should not be deemed as actions taken against the best interests of Kazakhstan. If the subsoil user is in breach of the contract, the Government has the right stipulated in each subsoil use contract to take certain measures against such subsoil user up to contract termination. Subsoil users are extremely concerned with the new legal regime and believe that it considerably worsens the investment climate in the country. Its establishment raises doubt as to the efficiency and economic feasibility of investments in Kazakhstan's subsoil use sector. The international press has long ago stopped describing Kazakhstan as a country with a favorable investment climate, and the currently contemplated legal innovations cannot but confirm such views.

## **OIL AND PRODUCT MARKETING AND TRANSPORTATION**

### **General Provisions**

The main law regulating oil transportation is the Law On Oil. There are also a number of follow-up legal acts governing specific oil transportation issues. In addition, a number of legal acts approved by Kazakhstan's Anti-Monopoly Body regulate transportation tariffs.

The production and marketing of such petroleum products as gasoline (with the exception of aviation fuel), diesel fuel, and fuel oil are governed by the 2003 Law On Government Regulation of Production and Marketing of Individual Types of Petroleum Products amended in 2007. A number of follow-up acts of different levels have been approved in development of the provisions of the said Law, including the Kazakh Government decrees and acts of various ministries.

It should also be noted that the new Law On Licensing was approved in 2007 in an attempt to provide a conclusive list of activities subject to licensing in one legislative act without materially changing the system of licensing itself. The Government Decree levying a first ever customs duty on oil export was issued on April 8, 2008 and made effective on May 17, 2008. Before that, export duty had been levied on petroleum products only. The Decree of April 8, 2008 establishes that customs duty shall not be levied on crude exported by subsoil users under contracts stipulating customs duty exemptions.

## **Oil Transportation**

Of all oil and gas pipeline types, the Law On Oil singles out pipeline mains the legal regime of which is of special interest to oil exporters from Kazakhstan. The Law establishes that the main pipeline may be in government or other ownership, and is operated by the owner unless otherwise is provided by the contract. The Law provides that oil and gas pipeline mains may be attributed to strategic assets (Article 193-1 of the Civil Code of Kazakhstan). In that case, their alienation or encumbrance with third-party rights shall be allowed by Government permit only. Some oil and gas pipelines and interests in the companies owning such pipelines have already been categorized as strategic assets. The principle of equal access to main pipelines for all shippers and equal tariffs levied on all shipments has been established by law. The Law also stipulates that the owner shall not deny access to his main pipeline to any oil shipper provided the pipeline has spare capacity.

## **Petroleum Product Marketing**

The Government controls petroleum product production and marketing using such levers as licensing and technical regulation, setting minimal obligatory output rates to petroleum product companies, and product marketing and quality control. Anti-monopoly regulations are applied to natural monopolies and market domineering entities. The Law On Petroleum Product Marketing prohibits sales of crude and (or) gas condensate by petroleum product companies. The Law also provides that petroleum products may be sold by petroleum product companies, oil suppliers, entities selling through gas stations or from product storage facilities, which technically means that all entities other than those referred to above have no right to sell petroleum products. That conclusion is confirmed by the existing practice.

The Law On Petroleum Product Marketing establishes product transportation terms and conditions according to which only specially equipped and approved transportation facilities meeting the technical requirements to hazardous cargo transportation and technical operation rules are allowed to carry petroleum products.

## **Licenses**

Numerous types of activities associated with petroleum product production and marketing are subject to obligatory licensing. The procedure for obtaining

such licenses is governed by appropriate provisions of the Law On Licensing and follow-up legal acts establishing the requirements to the licensing procedure for certain types of activities and identifying the licensing body responsible for a specific type of activity.

In order to obtain the license the requestor should meet certain qualification standards established by law, specifically, he should have the needed production and technical base, adequately qualified staff of technical managers, licenses to specific operations, etc. The requestor and/or license holder must submit the documents in compliance with the Law to the authorized government body confirming that his organization meets the established standards.

## **Price Regulation**

The crude and petroleum products pricing policy falls under the jurisdiction of the Kazakh Government. Price regulation of goods, works, and services offered by natural monopolies is exercised in compliance with the Law On Natural Monopolies last amended in July 2008. Regulation and control of natural monopolies is vested in the Kazakh Anti-Monopoly Agency which has been given broad powers, including pricing regulation.

Price regulation of goods, works, and services provided by entities enjoying a domineering (monopoly) position on a given commodity market is exercised in compliance with the Law On Competition and Monopoly Restriction approved in July 2006 in place of the 2001 Law On Competition and Monopoly Restriction. Government regulation of market competition and imposing restrictions on monopoly activities are the responsibility of the Competition Protection Agency under the Kazakh Ministry of Industry and Trade (hereinafter, Anti-Monopoly Agency).

The entities enjoying a domineering (monopoly) position on a certain commodity market are included in the Government Register drafted by the Anti-Monopoly Agency. Such entities are obligated to provide certain data to the Anti-Monopoly Agency requested by law.

## **Transfer Pricing**

Control over the use of transfer prices is exercised on the basis of the Law On Government Control Over the Use of Transfer Prices approved in 2001. The aim of the government control over the use of transfer prices by parties to international business transactions is to identify deviations of the said prices from market prices in certain deals the list of which is established by the

Government and to adjust taxation. The said control is the responsibility of Kazakhstan's tax and customs bodies (hereinafter, authorized bodies) by special procedures. Specifically, by monitoring deals involving the goods included in specially approved lists and controlling compliance with the tax and customs laws.

Based on the results of monitoring such deals, the authorized bodies conducts an audit to identify deviations of the deal prices (if any) from the market price of given goods. In such a deviation is identified the authorized bodies adjust taxation accordingly and transfer appropriate payments to the state budget.

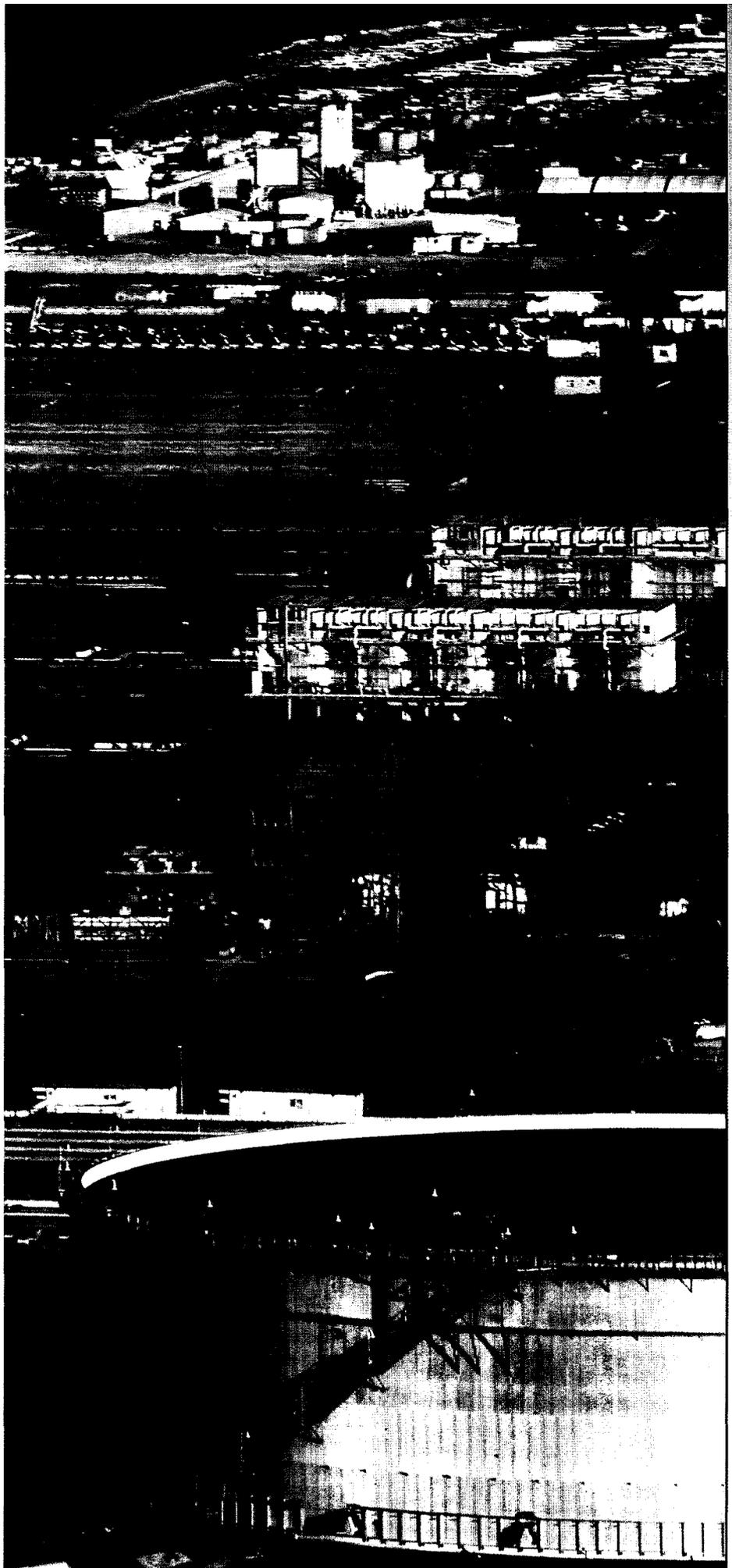
It should also be noted that on June 5 2008, the Law On Transfer Pricing was approved in Kazakhstan, which will come into effect on January 1, 2009. One of the most important innovations introduced by that Law is the obligation of the entities involved in such deals to provide annual reports in support of the deal monitoring. The Law also adds to the methods used for market price determination, introduced the principle of "arms length" deals, amend the list of deals subject to monitoring; describes rights and obligations of the authorized bodies, etc. The "arms length" principle means a principle used to determine the market price with due regard to the existing price range by comparison of the terms of deals among related entities with those completed among unrelated entities using market prices.

## **Competition and Control of Mergers**

The main legal acts regulating the issues of monopoly activity restrictions and protection of market competition are the Law On Natural Monopolies, the Law On Competition and Monopoly Restriction amended in 2007, and the Law On Unfair Competition amended in 2006.

**Anti-Monopoly Bodies:** the Kazakh Natural Monopoly Regulation Agency is responsible for the implementation of the Government policy with regard to natural monopolies. The Competition Protection Agency under the Kazakh Ministry of Industry and Trade submits notifications imposes restrictions, and terminates monopoly activities; protects competition and consumers' rights; controls compliance with the anti-monopoly legislation on any commodity market, including the oil sector.

In addition to imposing price regulation on natural monopolies and entities enjoying domineering position on any commodity market, the anti-monopoly legislation establishes a number of additional requirements protecting market competition and binding upon market participants.



### **Ban on Competition Suppressing**

**Agreements:** full or partial agreements (agreed actions) in any form among market participants which could suppress competition are prohibited and invalidated under the procedure established by the Kazakh law. The list of such agreements (agreed actions) is established by law.

### **Control over Economic**

**Concentration:** In order to prevent potential abuse of power by a market participant enjoying a domineering (monopoly) position on a given market or competition suppression the Anti-Monopoly Agency establishes government control over economic concentration by making certain deals (actions) stipulated in the anti-monopoly law subject to preliminary endorsement by the said Agency.

In particular, endorsement from the Anti-Monopoly Agency is required in the following cases:

- Establishment of a market participant which would control over 35% of a given commodity market;
- Reorganization (merger, takeover, restructuring) of a market participant enjoying a domineering (monopoly) position on a given commodity market.

The Anti-Monopoly Agency will endorse economic concentration if it does not create or strengthens the domineering (monopoly) position of a given market participant (group of entities) and/or suppress competition.

The Anti-Monopoly Agency is authorized to endorse economic concentration even if it suppresses competition if the entities involved in a given deal prove that the benefits from their action would outweigh the adverse impact on the relevant commodity market.

## **ENVIRONMENTAL PROTECTION ASPECTS**

### **General Background**

Kazakhstan's environmental protection legislation comprises the national law including the Environmental Code of Kazakhstan (hereinafter, Environmental Code or Code), laws and other legal or follow-up legal acts, as well as international agreements involving Kazakhstan.

**Environmental Code** is a supreme legal act establishing general regulatory provisions in the environmental protection sphere. The Code was approved on January 9, 2007 and became effective on February 3 of the same year. Such basic environmental laws as the Law On Environmental Protection, On Environmental Expert Review, and On Atmospheric Air Protection were invalidated with the approval of the Environmental Code. The



Environmental Code has a general and specific section, which facilitates legal unification in the environmental protection sphere.

**The General Section of the Environmental Code** contains basic provisions governing legal, economic, and social aspects of environmental protection activities and sets basic environmental protection requirements. This Section covers the basic principles of environmental legislation, the rights and obligations of subsoil users, the powers and responsibilities of the government bodies, outlines the subsoil use regime and licensing terms for certain activities involving the use of natural resources.

In addition, the General Section contains provisions addressing environmental protection standards, technical regulations, obligatory payments to the budget for the use of certain types of natural resources and atmospheric emissions. General environmental requirements to waste disposal, the issues of environmental expert review, environmental audit, and environmental impact assessments are also addressed in this Section.

**The Specific Section of the Environmental Code** establishes environmental protection requirements to specific types of economic and other activities, like the use of land, subsoil, water, forests, etc. A special chapter is devoted to liability for noncompliance with environmental protection requirements and environmental dispute resolution.

**Special Environmental Protection Regulatory Acts:** the oil and gas industry is governed by both general and special regulations including environmental protection regulations.

The Law On Subsoil contains a special chapter regulating subsoil conservation and environmental protection issues. In addition, the so-called "environmental norms" are provided in various articles of that Law and in the Law On Oil.

An important provision from the environmental perspective is a subsoil use restriction stipulated by the Law On Oil granting the Kazakh Government the right to prohibit the use of individual subsoil areas in the interests of environmental protection.

The Law On Subsoil contains a number of general environmental protection requirements binding upon subsoil users. The most important of them are the provisions preventing atmospheric pollution, requiring response measures in case of environmental damage caused by field abandonment (conservation) operations, and environmental damage payments covering actual damage incurred.

In 2004, a complete ban was put on associated gas flaring. In October 2005,

the Law On Oil was amended to include certain exemptions from that ban. Now the ban does not apply to subsoil users conducting oil operations under subsoil use contracts as of December 1, 2004 until they finalize their respective associated gas and (or) natural gas utilization programs. The said requirement applies only to the programs which were approved (endorsed) by the Government before December 1, 2004 or endorsed by the competent body and the authorized environmental protection body before December 1, 2006. However, flaring is allowed by special permit from the authorized government body responsible for subsoil studies and use and endorsement from the authorized environmental protection body. Pursuant to the Law On Oil amended in January 2007, meeting the schedule for associated gas and (or) natural gas utilization programs is an obligatory condition for obtaining the permit by way of exception from the generally applicable rule.

In addition, gas flaring is allowed in an emergency situation and in case of potential danger to the population health and natural environment. In exceptional cases, associated gas flaring is allowed subject to appropriate permits and endorsements in the process of well testing or experimental production over a period of up to three years.

In December 2005, the Law On Obligatory Ecological Insurance was approved under which civil legal liability of physical persons and legal entities conducting environmentally hazardous economic or other activities is subject to obligatory insurance. The list of environmentally hazardous operations is provided in a special decree of the Kazakh Government from which it follows that oil and gas companies may be obligated to buy environmental insurance.

Special environmental protection norms for the oil and gas industry are established in the National Oil Spill Prevention and Response Plan in Kazakhstan's Sea and Inland Water Pools, as well as in Kazakhstan's Conceptual Gas Development Program for 2015, and Kazakhstan's Petrochemical Industry Development Program for 2004 to 2010.

Other environmental legislation applicable to the oil and gas industry is fairly voluminous and exists predominantly in the form of Government decrees (usually highly detailed) or ministerial instructions. In addition to the list of such acts referred to in our earlier overviews, we would mention the most important ones issued in 2008:

- The Kazakh Government Decree #261 of March 18, 2008, Approving Rules for the Issuance of Permits to Contractors for Exploration and Recovery of Industrial Ground Water

the Amounts of Two Thousand Cubic Meters Plus a Day for Injection into the Reservoir in Compliance with the Technological Mineral Development Program in the Republic of Kazakhstan;

- The Kazakh Government Decree #95 of February 4, 2008, Approving the Rules for the Issuance of Comprehensive Environmental Permits and the List of Industrial Facility Types Potentially Subject to Comprehensive Environmental Permits Instead of Atmospheric Emission Permit.

### Important Provisions

The law distinguishes between **general and specific natural resource use**. The general natural resource use is continuous and free of charge; it meets vital needs of the population and calls for no special granting.

The core business of oil and gas companies is described as specific subsoil use conducted on the basis of:

- Licenses and (or) permits for the use of or drawing from natural resources and conducting certain types of environmental protection activity;
- Decisions of the Kazakh Government or local executive government bodies for granting the use of natural resources;
- Subsoil use agreements (contracts).

While in the past, pursuant to the Law On Environmental Protection the source of right to specific natural resource use was a subsoil use permit, now, pursuant to the Environmental Code, subsoil users are granted **ecological permits** for atmospheric emissions. No such permits are required if atmospheric emissions result from general natural resource use.

**Licensing Regime:** is established for physical persons and legal entities engaged in environmental protection design, standard setting, environmental expert reviews and environmental audit.

**Environmental Expert Review:** pursuant to the Environmental Code, a number of business operations are subject to state environmental expert review. The aim of such a review is identification and limitation of possible adverse impact of economic activities planned, as well as investment, standard setting, or other activities on the natural environmental and population health; maintaining a balance of environmental protection and economic development interests; preventing damage to third parties from subsoil use operations. In Kazakhstan, both the state environmental expert review and public environmental expert review are required.

**Industrial Control:** Entities engaged in specific natural resource use are obligated to exercise industrial environmental control aimed, among

other things, at ensuring compliance with the environmental protection law; providing information on environmental protection measures taken by companies to the general public, as well as on the existing risks to public health; improving the efficiency of the natural and energy resource use; taking into account environmental risks in taking investment and credit decisions. The industrial environmental control procedure is established by the Environmental Code.

#### (1) Payments by Subsoil Users:

subsoil users must make:

- Special payments, including
- Taxes, charges, and payments for the use of natural resources (land, water, fauna, guarded natural territories, etc.)
- Payments for environmental pollution (charged for pollutant discharges and emissions, disposal of industrial and household wastes, etc.)
- Payment for natural resource protection and replacement (in the form of compensation payable to the state budget).

(2) Payments of administrative nature, including:

- Payments for pollutant emissions (discharges), disposal of industrial and household waste above the permissible levels (additional charges);
- Administrative fines levied on officials and citizens guilty of noncompliance with the environmental law.

The amounts and rates of such payments are defined by the Tax Code of Kazakhstan.

**Environmental Insurance:** The aim of environmental insurance is the payment of damages caused by the entity conducting environmentally hazardous economic and other operations to the life, health, and property of third parties and (or) natural environment as a result of emergency pollution. Obligatory environmental insurance is governed by the Law On Obligatory Environmental Insurance.

**Guarded Natural Environmental Areas:** Certain zones in Kazakhstan have the status of *guarded natural environmental areas*. Oil exploration and production in such zones are conducted in compliance with special environmental regulations. The law also distinguishes subsoil areas of special environmental, cultural, and other value, and establishes a legal regime for such areas. Any activity posing danger to geomorphological and hydro-geological assets of the national environmental preserves is prohibited in such areas.

### Environmental Protection Sanctions

Liability for noncompliance with environmental protection requirements is regulated by various provisions of individual legislation branches,

including, the civil law, administrative, and criminal law.

The Criminal Code contains a special chapter establishing liability for environmental crimes, including criminal liability for atmospheric pollution, marine environment pollution, and noncompliance with the legislation on Kazakhstan's continental shelf, with the rules for subsoil conservation and use, the regime of guarded natural environmental areas, and other laws.

Liability for administrative noncompliance in the environmental protection sphere and the use of natural resources is regulated by a special chapter of the Administrative Code. Among other things, the said chapter establishes liability for failure to take environmental pollution response measures; noncompliance with the requirements to industrial environmental control; exceeding permissible levels of atmospheric pollution, or atmospheric emissions without a permit. The Administrative Code provides for sanctions for noncompliance with the law on obligatory environmental expert review; noncompliance with the development rules under mineral production and processing projects; illegal change in the license terms, as well as noncompliance with the approved rules for subsoil and other operations. 

### Aequitas Law Firm

Aequitas Law Firm is a leading company of this sector in Kazakhstan. Now already more than 15 years Aequitas offers a wide range of legal services to foreign and Kazakh clients, focusing mainly on subsoil development, corporate practices, including M&A, financial transactions, securities market, law of employment and arbitration.

Aequitas employs only high qualified professionals with fluent English. The Company's lawyers contribute as consultants to a number of international organizations and have been participating in the elaboration and improvement of the most important legislative acts of Kazakhstan as The Civil Code, The Law on Foreign Investment, The Law on Petroleum, The Law on Subsoil Resources and Development, The Law on Production Sharing Agreements.



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