



## NATURAL MONOPOLIES REGULATION IN KAZAKHSTAN

Importance of so-called natural monopolies in Kazakhstan can be seen in the fact that some of Kazakhstan's largest and most powerful corporate empires, such as the Kazakhstan Electricity Grid Operating Company (KEGOC) (national transmission grid operator), KazTransOil (national oil transporter in Kazakhstan accounting to 80% of all oil transported in the country) and National Company Kazakhstan Temir Zholy (the national railway company of Kazakhstan) are officially subject to natural monopoly regulation. The development of natural monopoly regulation in Kazakhstan can, therefore, be seen as an important test case for regulatory reform issues in countries with developing market economies.

Recently Government of Kazakhstan declared its intention to introduce competition into potentially competitive areas of the natural monopoly sectors and its readiness to improve the investment climate and to attract private investments (including through PPPs) into the housing and utilities sector, as well as other industries subject to natural monopoly regulation.

If successful, these initiatives would increase bankability and investment attractiveness of many projects in Kazakhstan.

Below is a brief recap for potential foreign investors and lenders of a current legal framework for natural monopolies in Kazakhstan, in particular description of the current tariff regulation.

### **Definition of Natural Monopoly in Kazakhstan**

The general definition is set forth in article 3(15) of the Law of the Republic of Kazakhstan 'On Natural Monopolies and Regulated Markets' No. 272-I dated 9 July 1998 (the 'NML') which states as follows: "natural monopoly shall mean the condition of services (goods, works) market, where the creation of competitive conditions for satisfying demand for a particular type of services (goods, works) is impossible or economically inexpedient due to the technical peculiarities of production and provision of the given type of services (goods, works)."

As article 1 of the NML states, that this law is aimed at (i) determination of the legal framework for the state control and regulation of activities in the natural monopolistic spheres and (ii) achievement of a balance of interests of the consumers and holders of natural monopolies. In other words, the purpose of this legislation is not only to regulate natural monopolies for the public benefit, but to mediate between the competing interests of all the parties involved, including those of the holders of natural monopolies themselves which are not conceived of as substantively different from, or less important than, the interests of any other private parties.

In accordance with the NML individual entrepreneurs and legal entities operating within certain enumerated industries which are recognised as '*natural monopolies*' are considered as so-called '*holders of natural monopoly*' that render '*regulated services (goods, works)*'.

Such industries include:

- 1) transportation of oil, oil derivatives via trunk pipelines;
- 2) storing and transporting natural gas via trunk and/or distribution pipelines, operation of natural gas pipelines, usage of natural gas distribution systems;
- 3) transportation and/or distribution of electrical energy;
- 4) generation, transpiration, distribution and/or supply with heat energy;
- 5) provision of electricity dispatch services;
- 6) services relating to organizing of balancing generation and consumption of electrical energy;
- 7) operation of main-line railways;
- 8) provision of railway services under concession agreements;
- 9) operation of branch railway lines;
- 10) air navigation;
- 11) airport and harbor services;
- 12) provision of telecommunication services, if there is no other competing telecom operator due to technical impossibility, or economical unfeasibility, except for universal telecommunication services;
- 13) leasing to other entities of duct banks and equipment for connecting telecommunication lines to terrestrial telecommunication network (of incumbent telecom operator);
- 14) operation of water and sewage systems; and
- 15) publicly available postal services.

### **Regulatory Agencies**

Save for telecommunication and publicly available postal services industries that have their own regulator (i.e. Ministry of Investment and Development of Kazakhstan (the '**MID**') as successor of the reorganised Agency for Communication and Information), the newly formed Committee on Regulation of Natural Monopolies and Protection of Competition of the Ministry of National Economy of Kazakhstan (the '**AREM**'), as successor of the reorganised Agency of the Republic of Kazakhstan On Regulation of Natural Monopolies, regulates the rest of natural monopolies

and maintains a registry<sup>1</sup> of entities operating within below mentioned industries. Functions of the AREM as authorized body include control and regulation of activities in the sphere of natural monopolies (save for telecommunication and postal services), it also has the right to develop and approve by-laws that are binding for state bodies and subjects of natural monopolies.

### **Forms of Regulation and Control**

The regulatory regime contemplated by the NML includes two major elements: (1) regulation *per se*, and (2) supervision and control in the form of pre-approval of certain acts intended to be engaged into by the holders of natural monopolies.

#### *Forms of Regulation*

Provisions that reflect general approaches to regulation are contained, in particular, in articles 5, 6, 7 of the NML (“*Restrictions of activities of holders of natural monopolies*”, “*Rights of a holder of the natural monopoly*” and “*Duties of a holder of the natural monopoly*”) that are, in essence requirements:

- ✓ to provide equal conditions to consumers of services (goods, works) manufactured in the conditions of natural monopolies (except for provision of benefits to certain categories of consumers in accordance with the legislation);
- ✓ to ensure quality of services for consumers taking into consideration prices set by the regulator that supervises activities of holders of natural monopolies;
- ✓ to apply efficient production methods and technologies;
- ✓ to submit to the regulator that supervises activities of holders of natural monopolies reports on their activities.

State regulation of the holders of the natural monopoly under the NML is performed through:

- 1) the approval of a tariff (price, fee rate) or a maximum limit thereof including by applying a comparative analysis method, differentiated and investment tariffs (prices, fee rates);
- 2) the approval of a tariff estimate;
- 3) the approval of a temporary decreasing coefficient;
- 4) the approval of a special procedure for incurring costs;
- 5) the approval of a procedure for keeping separate records of income, expenses and involved assets by each type of regulated services (goods, works) and for the other activities in general;
- 6) the approval of accounting policies;
- 7) the approval of temporary compensating tariff.

*Forms of Control* The holders of natural monopoly are subject to specific restrictions and additional obligations, for instance, the holders of the natural monopoly cannot (save for limited exceptions as specified in article 5 of the NML), *inter alia*:

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<sup>1</sup> Such register of natural monopolies consists of the Republican (for most important companies) and local parts (for local level companies).

- ✓ render services and perform other activities not relating to natural monopoly spheres;
- ✓ own property unrelated to the production and provision of regulated services (goods, work);
- ✓ hold shares (participation interests) or otherwise participate in the activities of commercial organizations;
- ✓ charge for the regulated services (goods, work) in excess of the established amounts; and
- ✓ charge additional payment or otherwise impose additional obligations unrelated to the subject of services;
- ✓ prevent the excess of the funds provided for by items of the tariff estimate approved by the competent authority by more than five percent, except for regional electricity network company, and cases of increase in expenses for the used strategic goods, as well as natural and man-made emergencies;
- ✓ include in tariffs (prices, fee rates) or their maximum limits for the regulated services (goods, works) costs unrelated to their provision;
- ✓ allow unauthorised use of the funds provided for in investment programs (projects) approved in accordance with the established procedure;
- ✓ classify as commercial secret the information: (i) contained in the tariff estimate; (ii) on expenditures for procurement and installation of metering devices for regulated public utility services and the mechanism of collecting charges, procurement and installation of metering devices for regulated public utility services; (iii) on provided regulated public utility services (goods, works).

It worth mentioning that for the purpose of flexible regulation of low-capacity enterprises, the NML envisions a simplified procedure for so-called '*low capacity natural monopoly entity*' that is a natural monopoly entity that provides, for instance, services of production, delivery, distribution and/or supply of thermal energy from heating boiler-houses with a total installed capacity of up to twenty Gcal/hour inclusive.

Finally, it should be noted that activities of natural monopolies in Kazakhstan are subject to stringent regulations and, for instance, holders of natural monopolies are required to obtain approval from the regulatory agencies for certain types of business transactions, in particular, sale, lease or other disposition of the assets of the natural monopoly company, designated for production and rendering of regulated services (goods, works), by such natural monopoly company, if the book value of such assets exceeds 0,05% of the book value of whole assets of the holder of natural monopoly as of beginning of respective year. For the approval of such transactions, the holder of natural monopoly must apply to the AREM and provide the latter with the necessary information (as determined by the agency) about the contemplated transaction. The regulatory agency may deny its approval if it deems that the transaction will have an adverse effect on the interests of consumers or on a competitive development of the market, in which case the applicant can appeal to the court. Similarly, a notification of the AREM is, for instance, required for any acquisition by third parties of a stake in a holder of natural monopoly giving them more than 10% of the votes on the shares of such a holder.

## Tariff Regulation

### *Key Principle and Tariff Setting Specifics*

The main tariff setting principle contained in the NML states that tariffs or their cap levels for regulated services (goods, works) of a subject of the natural monopoly approved by the authorized bodies have to be not lower than the value of costs needed to provide these regulated services (production of goods, works), and have to take into consideration possibilities of getting profits that would ensure efficient functioning of a subject of the natural monopoly.

Tariffs in Kazakhstan are, generally, designed based on the cost plus method (*затратный метод*) under which a standard mark-up is added to the cost of a product.

### *Legal Basis*

In Kazakhstan the current legal basis of the state tariff regulation is comprised of the following key legal acts:

- 1) NML;
- 2) Industry specific laws;
- 3) numerous by-laws (e.g. Decrees of the Government of Kazakhstan) and by-laws issued by the regulator (e.g. Orders of the Chairman of the AREM).

The legal basis of the current tariff setting methodology in the field of natural monopolies in Kazakhstan are by-laws that determine:

- 1) the procedure for determining costs that are taken into account in the calculation of prices (tariffs) for production and provision of services (goods, works) by subjects of natural monopolies;
- 2) procedure for procurements by subjects of natural monopolies of goods, works and services, costs associated with which are taken into consideration when approving tariffs; and
- 3) procedure for presenting, reviewing and introduction of prices (tariffs) for goods, works and services of subjects of natural monopolies.

### *Types of Tariffs*

Under Kazakhstan's legislation, tariffs charged by a holder of natural monopoly are regulated. Prices for services (goods, works) produced by the holder of natural monopoly<sup>2</sup> will be, therefore, subject to:

- 1) either [standard] tariffs (the '**Standard Tariff**') approved for a certain period of time, but generally for a short term period; or
- 2) Cap levels of tariffs (the '**Maximum Tariff**') approved for long run period;

In certain cases also following special types of tariffs can be used:

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<sup>2</sup> I.e. irrespective of the industry these tariffs shall be applicable to, generally, all natural monopoly companies (save for regional electricity grid companies).

- 3) Investment tariffs;
- 4) Differential tariffs.
- 5) Compensatory tariff;
- 6) Tariff with Method of Comparison Analysis (applicable to regional electricity grid companies only);
- 7) Special tariff under the concession agreement, whichever is applicable in each particular case.

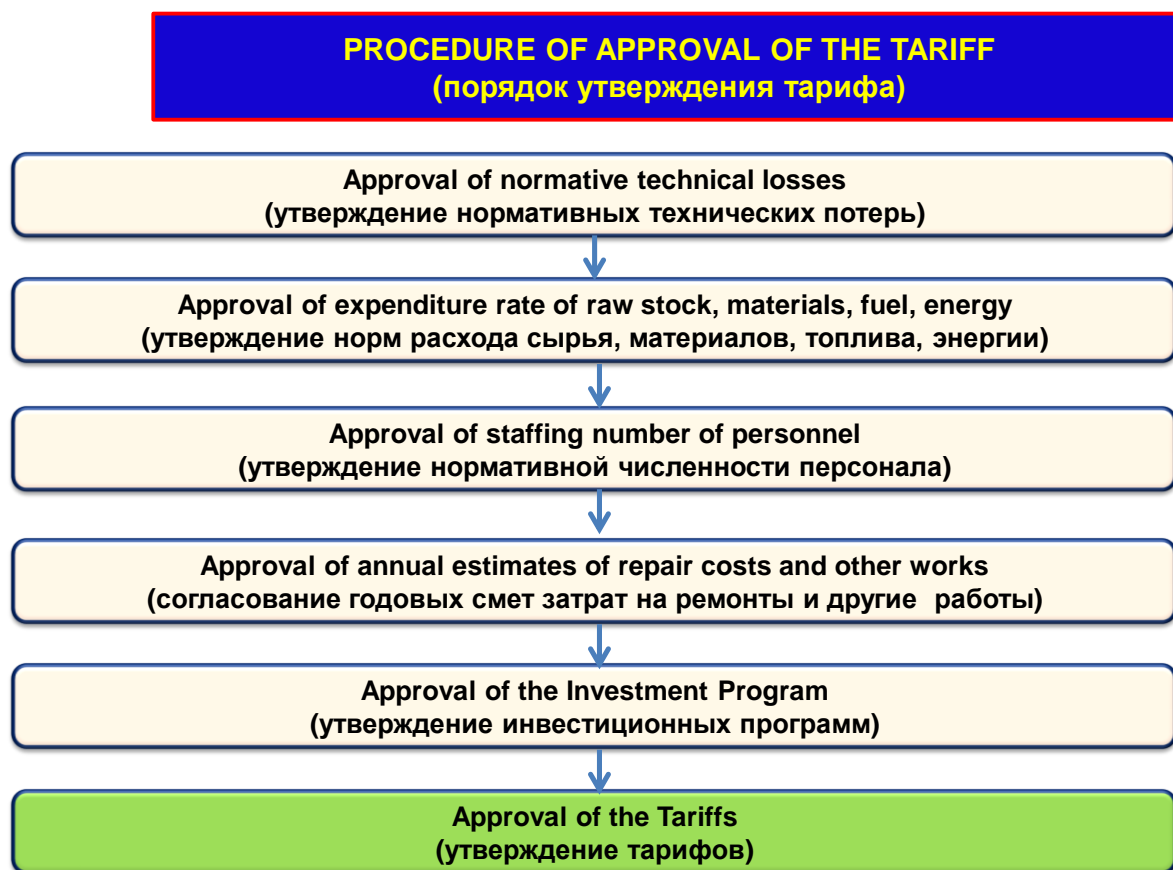
*Standard Tariff (пределный тариф)*

The very notion of “tariff” defined in the Kazakh Law envisions monetary value of the cost of regulated services (goods, works) of a subject of the natural monopoly approved by the authorized body. Natural monopoly entities, therefore, are obligated to provide services (goods, work) subjected to regulation at the tariffs (prices, fee rates) as approved by the authorized agency (i.e. AREM or MID as applicable, the '**Regulator**').

In order to be able to use the standard tariff, a holder of natural monopoly must go through quite lengthy, not transparent and bureaucratic procedure (see Annex 1 below for simplified recap of majors steps to be taken).

Revision of existing or introduction of the new tariff may be initiated either by the subject of natural monopoly itself or by the relevant Regulator as per procedures stipulated in the AREM Order 215 - ОД.

**Annex 1**



#### *Maximum Tariff (предельный уровень тарифа)*

If a natural monopoly company's investment obligations cannot be fulfilled out of sales on the basis of the short-term standard tariff and to be able to attract long-term investments as per 'tariff in exchange of investments' state policy, the company may use so-called maximum tariff that is a maximal value of tariffs (prices, rates) for the medium-term (more than 1 year up to 5 years) or long-term (more than 5 years) period. Once a maximum tariff is approved by the Regulator, a natural monopoly company may set its own tariff for the sale of its regulated services (goods, works) based on an agreement with a counterparty, however, this tariff must not, in any event, exceed the approved maximum regulated tariff for the respective year.

Procedure of approval of the maximum tariff is almost the same as procedure applicable to the standard tariff described above.

#### *Investment Tariff (инвестиционный тариф)*

A specific feature of the Kazakhstan legislation on natural monopolies is that the Regulator for the newly developed facilities can set forth a specific tariff or its maximal value (cap) for regulated services for one particular investment project only, and such tariff shall be valid until full recovery of the investments.

Prerequisites for setting investment tariffs are upgrade of existing and/or creation of new assets.

#### *Differentiated Tariff (дифференцированный тариф)*

In accordance with article 3(12-2) of the NML differentiated tariff means a tariff on regulated services of a natural monopoly entity approved by the competent authority and differentiated by groups of consumers and/or consumption volumes. So far differentiated tariffs have been introduced for electricity (differentiation depends on time zones and consumption), water (differentiation depends on groups of consumers, consumption and presence of the metering device) and heat (differentiation depends on presence of the metering device).

*Compensatory Tariff (временный компенсирующий тариф)*

In case a subject of the natural monopoly causes losses to a consumer by means of unlawful increase of tariffs (prices, rates) or their cap values and/or by means of including in the tariff (price, rate) or its cap level the cost of actually not executed works, non-targeted use of depreciation funds envisioned in the tariff budget, deviation of execution of cost items by more than five percent from approved amounts, the authorized body has to make a decision on approval of the temporary compensatory tariff to compensate consumers for losses.

Meanwhile, the revenue taken to justify the level of new tariffs (prices, rates), is decreased by the amount of groundlessly received revenues taking into consideration the refinance rate of the National Bank of the Republic of Kazakhstan as of the date the decision was made less amounts already compensated by the subject of the natural monopoly to consumers of its regulated services (goods, works).

*Tariff with Method of Comparison Analysis  
(Тариф с применением метода сравнительного анализа)*

Each regional electricity grid company (so-called 'PЭК') in Kazakhstan benefits from special tariff set by using the so-called comparative analysis method (i.e. not cost plus method used by most natural monopolies in Kazakhstan discussed above, but method based on comparison against effectiveness of operation of other regional electricity grid companies). Such special tariff can be approved by the Regulator for not less than five years with yearly breakdown and shall be adjusted on an annual basis given the effectiveness of its activity.

The advantage of this method against cost plus method is that natural monopoly company using this method can independently distribute and optimize its expenditures within the prescribed tariff revenue, evidently, in most efficient way and, at the same time, each PЭК individually is expected to improve its performance.

*Special Tariff Under the Concession Agreement*

Because of the recent and not yet tested law “On Introducing Amendments to Certain Legislative Acts of Kazakhstan for the Introduction of New Forms of Public Private Partnership and Extending the Application Area” (No. 131-V, dated July 4, 2013), subjects of natural monopolies in Kazakhstan that executed so-called concession agreements can, evidently, have their own special tariffs<sup>3</sup> to be stipulated in the concession agreements. It seems that concessionaires in Kazakhstan are, therefore, largely exempted from general tariff limitations discussed above (e.g.

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<sup>3</sup> That shall be, apparently, determined on the basis of special calculation procedures - i.e. arguably, formula based tariffs.



when AREM decided to lower the tariffs applicable to all other natural monopoly subjects, the concessionaire that is a natural monopoly will be protected until its concession agreement is effective). It does not mean, however, that concessionaires that are natural monopolies are not regulated by the AREM. AREM has the right to participate in the approval of feasibility studies, tender documentation and draft concession agreements including any amendments related to tariff changes, and monitor the implementation of the concession agreement in terms of compliance with the tariff stipulated in the concession agreement.

As a side note, it worth mentioning that current legislation allows to make changes in already effective tariffs in certain cases as specified below:

#### *Temporary Decreasing Ratio*

For the purpose of protection of interests of consumers and those of a subject of the natural monopoly in Kazakhstan, the Regulator can set a temporary decreasing ratio – a value that is applicable to the tariff (price, rate). Approval of the temporary decreasing ratio to the tariff is made on the basis of the rules in various fields of operations of natural monopolies approved by the authorized body, upon the request from a consumer who encloses substantiating documents, provided the consumer paid 100 % his/her current liabilities and there are no payables due. Temporary decreasing ratio comes into effect from the first day of the month for a certain period of time but not more than for one calendar year, except for some cases specified in the rules.

#### *Change of the Tariff because of Change of Tax Legislation*

Upon prior approval by the Regulator, a natural monopoly can increase its tariff for all its consumers provided it can justify such increase by evidence of change in tax legislation of Kazakhstan that affected operation of the company.

### **Public nature of the tariff regulation procedure**

Public nature of the process of the tariff design in Kazakhstan is ensured by (i) participation of independent experts, NGOs and consumers in the process of evaluation of draft tariffs submitted by the natural monopolies and (ii) public hearings, though any opinions expressed by participants during such public hearing are of advisory nature only.

In Kazakhstan public hearings are envisioned in the form of open meetings of the regulator, as well as it is envisioned that due notifications time and venue of such public hearings have to be published in mass media and on the Internet site of the natural monopoly.

Participants of public hearings are, usually, the Regulator (organizer), representatives of interested state bodies<sup>4</sup>, consumers and subjects of monopolies. As discussed above comments and proposals of participants are non-binding for the Regulator.

In order to ensure better awareness and preparedness of participants of public hearings, the NML envisions that after information on the date of conducting public hearings is published, the subject of the natural monopoly has to provide upon requests of participants of public hearings

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<sup>4</sup> If the natural monopoly company is registered in the local registrar of natural monopolies, respective Akimat shall be invited to attend the public hearings.

drafts of tariff estimates, tariffs for regulated services or their cap values, information on the reasons for increasing tariffs for regulated services or their cap values with economically justified calculations.

Also every natural monopoly company is obliged to conduct reports on its activities on annual basis. Such annual report shall be conducted in the form of public hearings before consumers and other interested parties but again comments and proposals of participants of such hearings are non-binding for the Regulator and the natural monopoly.

Importantly, Kazakhstan law prohibits recognition as a commercial secret information (i) contained in the tariff estimate, (ii) on costs associated with acquisition and installation of devices for measurement of regulated utility services and the mechanism of charging payments, acquisition and installation of devices for measurement of regulated utility services and (iii) on provided regulated utility services (goods, works).

It also should be noted that there is statutory obligation for the subject of the natural monopoly to inform consumers about changes in tariffs (prices, rates) or in their cap values not later than thirty days before they come into effect.

Finally, Kazakhstan law envisions the duty of the subject of the natural monopoly to publish audit report and annual financial statements in periodicals.

To the best of our knowledge, above provisions of law do not work in practice and often ignored by the natural monopolies.

### **Recent Legal Developments**

- 1) To the best of our knowledge, there is a draft law 'On making certain amendments to certain legal acts of the Republic of Kazakhstan in relation to issues of natural monopolies and regulated markets' under consideration of the Parliament of Kazakhstan that provides<sup>5</sup> for, among other major novels, (i) exclusion of transportation of oil and gas for export or transit from list of regulated services and (ii) introduces qualification requirements for any candidate who wants to become the head of a natural monopoly company (e.g. university diploma, experience etc).
- 2) Kazakhstan is a member of the Eurasian Economic Union and the Eurasian Economic Commission operates a competition policy to ensure equal competitive conditions in the commodity markets of the Single Economic Space. It also aims at harmonization and improvement of legislation of each of the three countries in regard to competition policy. The commission serves as the competition regulator for the single market and is also responsible of antitrust issues.

International treaty on Unified Principles and Rules of Regulation of Activities of Natural Monopolies has been executed on December 9, 2010 among the Governments of the Republic of Belorussia, Republic of Kazakhstan and Russian Federation that, for instance, requires prior approval of the Commission of the Union if it want to expand the list of industries that shall be considers as natural monopolies and such industry is not natural monopoly in any of the member-state of the Union.

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<sup>5</sup> We rely on draft law dated 30 May 2014 that is in public domain.

- 3) To the best of our knowledge, there is a draft of the Program for Tariff Policy for Natural Monopolies and Regulated Markets until 2020 prepared by the Ministry of National Economy of Kazakhstan and, evidently, currently under further elaboration by respective state authorities. Major conclusions made in this Program<sup>6</sup> are as follows:
- (i) Cost plus method used now by most natural monopoly in all industries for tariff setting shall be replaced with long-term Maximum Tariff that proved to be effective for attracting long-term investments for power producing companies.
  - (ii) Relevant regulations shall be eased in relation to application for approval of the tariff and tariff estimates and investment programs as currently whole procedure is non-transparent and bureaucratic.
  - (iii) Statutory limitations imposed on natural monopolies (e.g. prohibition to engage in non-regulated services) shall be eased and natural monopolies shall be able in addition to regulated services to gain profit from other non-core activities.

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<sup>6</sup> We rely on the draft currently available as of September 1, 2014.