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DRAFT AMENDMENTS TO PROCUREMENT RULES FOR PETROLEUM COMPANIES

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The Procurement Rules¹ play an important role in the day-to-day activities of the petroleum companies operating in Kazakhstan, considering that requests to clarify procurement issues constitute 55% of all requests for clarification of subsoil use issues sent to the Minister of Energy's blog in 2019. This article reviews how the Procurement Rules are applied and the proposed amendments that will change or facilitate the procurement process.

Background

According to the *Ministry of Energy (MoE)*, as of January 1st 2020, there were 235 subsoil use contracts (**SUC**) for hydrocarbons, including 54 exploration contracts, 74 production contracts, 96 combined exploration and production contracts, and 11 production sharing agreements.

The majority of subsoil users must procure goods, works, and services (**GWS**) under the Procurement Rules. However, these Rules do not apply to the so-called "stabilized contracts" for the Tengiz, Karachaganak, Kashagan, and Dunga fields, nor do they apply to subsoil users for which 50% of the voting shares (stakes) directly or indirectly belong to the *Samruk-Kazyna Sovereign Wealth Fund (KazMunayGas* and some of its affiliates).

What Happens if GWS Procurement Does Not Comply with the Procurement Rules?

If GWS procurement does not comply with the Procurement Rules, the holders of SUCs signed prior to 29 June 2018² risk having their related expenses disallowed by the MoE as expenses related to their financial obligations under the SUCs. If this occurs and leads to underperformance of financial obligations, it will be regarded as non-compliance with the SUC work program, which entitles the MoE to:

- impose a penalty established by the SUC (depending on the SUC, this may range from 1% to 30% of the unfulfilled obligations); and/or
- unilaterally terminate the SUC if the subsoil user's fulfillment of its financial obligations is less than 30% over two subsequent years.

¹ *Rules for Procurement of Goods, Works, and Services for Exploration and Production of Hydrocarbons and Production of Uranium by Subsoil Users and their Contractors*, were approved by the Ministry of Energy's Order dated 18 May 2018 No. 196 and amended as of 31 December 2019 (the "Procurement Rules" / "Rules"). <http://adilet.zan.kz/rus/docs/V1800017122#z3> (Rus).

² The date when the *Code for Subsoil and Subsoil Use* dated 27 December 2017 (the "Subsoil Code") entered into force.

Holders of SUCs signed after 29 June 2018, including subsoil users that transitioned to a new SUC model, risk penalties by the MoE in accordance with their contracts – 5% of the expenses related to the procurement that are not in compliance with the Rules.

The MoE has prepared amendments to the Procurement Rules, the first draft of which was circulated among members of expert councils in June 2019. The latest updated draft – the **Draft Amendments** – was published with some minor changes on legalacts.egov.kz³ with the expiry date for public discussion on 24 February 2020.

When this article was written, the amendments had not yet entered into force. Before that, approvals are required from the related ministries, and the Justice authority must register and publish the amendments. It is likely that the amendments will be approved soon without further changes.

How the Rules are Applied

When a subsoil user intends to procure a specific type of GWS, it uses the following algorithm (a negative result for one stage leads to the next stage):

- First, the subsoil user checks whether this type of GWS is listed in Annex 1 to the Rules, referencing GWS that may be purchased without other types of procurement.
- Second, the subsoil user checks whether a sole-source procurement is possible (clauses 84-85 of the Rules).
- Third, the user checks whether the goods to be procured are named and correspond to the minimum supply volumes set forth in the *List of Commodity Goods* approved by the *Minister of the National Economy's Order No. 142*, dated 26 February 2015. The *Commodities List* is very short and de facto this option is not used.
- If the previous options do not apply, the subsoil user may procure GWS either through an open tender (with confidential bids) or an open tender for price reduction (electronic trades) in which all bids can be viewed by the participants. Either of these two methods will be referred to below as the "tender".

If the tender results are not successful, the subsoil user is entitled either to conduct a new tender or to procure the GWS under sole-source rules.

The following sections outline stages of the procurement process and the anticipated amendments to this process in more detail.

³ <https://legalacts.egov.kz/npa/view?id=3094660> (Rus).

Impact of the Amendments on the Procurement Process

GWS procurement without other types of procurement

There are currently 40 clauses in Annex 1 of the Rules allowing subsoil users, *inter alia*, to bear expenses related to employee training, seminars, conferences, cleaning and catering services, rental of real estate, arbitration and court proceedings, communications (telephone, cellular, and internet), office supplies, medical services, and so forth. Subsoil users may also procure a specific type of GWS if its cost does not exceed 500 monthly calculation indexes (MCI) per year equivalent to ₸ 1,325,500 in 2020.

Subsoil users' contractors are allowed to procure works or services for an amount not exceeding 100,000 MCIs (₸ 265,100,000 in 2020) per year. In addition to minor amendments to the current clauses in Annex 1, the Draft Amendments provide four additional clauses allowing subsoil users to:

- purchase railway and air tickets;
- purchase fuel and lubricants;
- reimburse a new subsoil user's expenses for acquisition of infrastructure facilities, equipment, and other goods during transfer of the subsoil use right from a previous subsoil user; and
- purchase GWS for joint development under Article 150 of the Subsoil Code (*Joint Development of Fields at Different Subsoil Plots*) if the subsoil user participates in joint development with a user holding a stabilized contract.

Sole-source procurement

Sole-source procurement is allowed if either:

- a tender is unsuccessful or the winner (or a 2nd-place bidder) fails to sign the contract or, after signing the contract, does not provide the required performance security (clause 84); or
- the GWS is listed in clause 85 of the Rules.

In addition to the current 10 types of GWS that may be sole-sourced, the Draft Amendments provide for 3 additional types:

- goods of Kazakhstani origin if economically feasible for subsoil users;
- amending pre-project and project documentation by the initial project design company;
- GWS for technical maintenance during the guarantee period for technical support of licensed software.

In addition, research and development may be procured during the production phase as well as during exploration.

Procurement through a tender

What are the major anticipated amendments to an open tender procedure? These amendments also apply to open tenders for price reduction (electronic trades) as both types of tenders are generally equal, differing only in the procedures for submitting price proposals and selecting the winner.

Document matching

The Draft Amendments introduce a new chapter for the document matching procedure, which is similar to some extent to the previous document verification procedure. This is not mandatory, but a tender commission may require that the winner provide original documents or notarized copies of certain documents within 5 business days (7 business days for non-residents).

Within 5 business days after receipt of the documents, the commission reviews them and, on the following business day, issues the document-matching Minutes. With document matching, the total timeframe for executing the procurement contract after the tender results is extended from 25 to 40 business days from the date of either the Minutes of the results or the document-matching Minutes.



New threshold

Under the Rules, if a subsoil user procures work or services in an amount exceeding 14,000 MCIs (₸37,114,000 in 2020) per year, potential suppliers may be required to provide evidence of their related work experience for the past 5 years. The Draft Amendments provide for an additional threshold equal to 30,000 MCIs (₸79,530,000 in 2020). The documents proving work experience for the last year may be either for the current or previous fiscal year.

Other amendments

Other significant changes in the Draft Amendments include the following 10 items:

- The composition of a tender commission may be changed only before summarizing the tender results or the document-matching results (if available).
- Bidders may submit their bids in Kazakh and/or in Russian (previously both in Kazakh and Russian).

- A potential supplier's failure to upload or update relevant foundation documents to the register (*reestr.nadloc.kz*) or other e-procurement systems synchronized with the register may serve as grounds to reject the supplier's tender bid.

(In practice some potential suppliers either do not provide their foundational documents (clean white sheets are uploaded) or they provide an incomplete package of documents (e.g., members of consortia).

- If a tender is cancelled due to the tender's non-compliance with the Procurement Rules or Kazakhstan law, in order to conduct a new tender, the original tender documentation may be changed only in the section where the defects were removed, along with extending deadlines for supplying goods and performing work and services (if necessary).



(This amendment aims to prevent the following practice. If a subsoil user discovers a violation of the Rules, before signing the contract the user may request that the tender be cancelled and a new tender be held within one month. In practice, some subsoil users, after opening and reviewing the bid proposals, cancelled the tender, tightened tender requirements for competing contractors, and requested a new tender.)

- To confirm compliance of works and services with their functional, technical, qualitative, and operational requirements, potential suppliers may, *inter alia*, provide copies of lease agreements. Any third party referred to by a potential supplier may act only as a co-member of the consortium and not as the potential supplier's subcontractor.
- A non-resident winner may provide their counter-signed contract within 7 business days (residents have only 5 business days).
- If the winner does not sign the contract, the subsoil user, in addition to the current option of signing it with the 2nd-place bidder (if available), has the right to conduct a new tender.

(There are cases where affiliated suppliers took advantage of the current provision obliging subsoil users to conclude contracts with the 2nd-place bidders.

How did this occur? The winner, having proposed a lower amount, refused to sign the contract, and the 2nd-place bidder then offered a higher price equal to the initial budget amount. Accordingly, the subsoil user had no choice but to sign the contract with the 2nd-place bidder).



- Kazakhstani manufacturers must be paid for goods of Kazakhstani origin within 30 calendar days from signing the acceptance acts (all other suppliers are paid within 60 calendar days).
- The subsoil user and the tender winner may refuse to sign a contract if, between the date when bids are opened and the date when the contract is signed, the official exchange rate changes by more than 10 % – unless both parties agree to change the contract price accordingly.
- If the cost of fuel and lubricants increases or decreases, the price of a signed contract for vehicle services may be amended accordingly.

Conclusion

The Draft Amendments appear to effectively close major loopholes used by some subsoil users or potential suppliers acting in bad faith. Moreover, the amendments will remove unnecessary procurement obstacles and expand the range of GWS that may be procured relatively easily by subsoil users. Kazakhstani manufacturers are given certain preferences. Finally, after the amendments enter into force, there will be less ambiguity about the Procurement Rules.

