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Key Potential Changes in Oil and Gas Regulation

1. Background

The Republic of Kazakhstan (“RoK”) wishes to change its subsoil use legislation and replace the current Law on Subsoil and Subsoil Use dated 24 June 2010 (the “Law”) by a new Code on Subsoil and Subsoil Use (the “Code”).

The concept of the Code was approved in mid-2015. Interim versions of the Code were circulated among accredited entrepreneurial associations for consideration in February, May, December 2016, February and March 2017.

The Code, a separate law on enactment of the Code (the “Enactment Law”) and a law on introduction of amendments to certain RoK legislative acts with regard to subsoil use issues (jointly the “Amendments”) are planned to be submitted to Kazakhstan Parliament for finalization in September 2017[1] with its adoption and entering into force from 1 July 2018.

The Code is prepared jointly by:

(i) the RoK Ministry of Energy (the “Ministry”) which as a competent authority for oil and gas subsoil users elaborated oil and gas issues of the Amendments; and

(ii) the RoK Ministry of Investment and Development responsible for elaboration of solid minerals issues.

Due to limited volume, this article deals only with potential key changes related to oil and gas subsoil users, which contracts have/will have been concluded before the Amendments enter into force (“current subsoil users”).

(Note: According to official information[2], as of 1 January 2017, there are 145 oil and gas subsoil users in Kazakhstan holding 214 subsoil use contracts for 236 areas (deposits), including 59 exploration, 73 production and 104 combined exploration and production regimes.)

What should current subsoil users expect from the Amendments? Below are our conclusions made on the basis of the last version of the Amendments (end of March 2017).

2. What will the Code apply to?

The Code will apply to subsoil use relations arising after its enactment, save for certain exceptions set out in the Enactment Law.

3. Status of current licenses and contracts

All current subsoil users’ licenses (received before August 1999) and contracts preserve their force, as well as their project documents. However, any amendments to project documents shall be made according to the Code. Amendments to the contracts shall be made as set out by the Enactment Law, being in principle the same as the current order of execution of amendments to the contracts.

4. Major obligations remaining in force

Obligations to provide annual, middle-term and long-term procurement programs, reports on (i) procured GWS, (ii) local content in staff, (iii) financing tuition of Kazakhstani staff, (iv) financing research and development works will preserve their force for current subsoil users.

(Note: Under the Code Kazakhstani suppliers of works and services will be individual entrepreneurs and Kazakh legal entities operating in Kazakhstan and (i) having $\geq 50\%$ of Kazakhstani citizens in staff (currently – $\geq 95\%$), (ii) not taking into account managers and specialists working in Kazakhstan within intra-corporate transfer with the threshold $\leq 25\%$ within each relevant category.)

5. Procurement of goods, works and services

According to the Enactment Law, the general order of procurement of goods, works and services (“GWS”) set out by a slightly amended Article 77 of the Law preserves its force for current subsoil users.

We note the amended (under the Enactment Law) Article 77 of the Law does not stipulate that violation of the procurement rules entails exclusion of relevant expenses from expenses taken into account by the Ministry as performance of contractual obligations by a relevant subsoil user (such sanction is set out by the current wording of Article 77.6 of the Law).

However, as according to Article 116.4 of the draft Code the Ministry will be entitled to apply such sanction to new subsoil users (i.e. those which contracts will be concluded after enactment of the Code), most probably the final version of the Enactment Law will preserve the Ministry’s right to apply such sanction to current subsoil users.

6. Local content in goods

For contracts concluded before 1 January 2015 the obligation on local content in goods preserves its force until 1 January 2021. If term of such a contract is extended, the obligation on local content in goods shall be excluded.

7. Unilateral termination of the contract by the Ministry

Provisions of Article 72 (Termination of Contract) of the Law will be replaced by provisions of Article 94 (Early Unilateral Termination of Subsoil Use Contract by Competent Authority) of the Code.

In addition to the Ministry's right to unilaterally terminate a subsoil use contract in case of:

- (i) a failure to timely eliminate more than two violations of obligations under a subsoil use contract within the period of time set out by the Ministry (6 months for physical obligations, 3 months for financial obligations and 1 month for other obligations);
- (ii) a failure to comply with the Code’s requirements pertaining to transfer of subsoil use right and change of control over a subsoil user (see below section 8 of this article regarding change of control over a subsoil user);
- (iii) performance of less than 30% of financial obligations set out by a subsoil use contract within 2 consecutive years;

(iv) a situation when subsoil user's actions on a Strategic Plot (as defined below) lead to a change in the RoK economic interests which poses a threat to the national security, including in case of refusal of the subsoil user to conclude amendments to the contract on restoration of the RoK economic interests within the estimated period (up to 6 months); -

Article 94 of the Code entitles the Ministry to unilaterally terminate the contract in case of:

(v) entering into force of a court resolution on freezing subsoil use activities due to violation of ecological and industrial safety requirements;

(vi) submission of intentionally unreliable reports (according to the Code all subsoil users shall annually submit audited reports to the Ministry by 30 April of the year following the reporting period);

(vii) non-submission of audited reports;

(viii) carrying out subsoil use operations without project documents (a) approved by subsoil users and (b) having positive expert conclusions set out by the Code; an

(ix) carrying out oil and gas operations, connected with disruption of the earth surface without providing security for abandonment.

For the last above three cases the Ministry notifies a subsoil user in writing and the subsoil user is entitled to eliminate the violation within 3 months.

If the Ministry decides to unilaterally terminate a contract, it sends to the subsoil user a 2-month advance notice on termination of the contract. Unilateral termination is not allowed if after receipt of such notice the subsoil user provides the Ministry with evidence regarding force-major circumstances. The subsoil user that received a notice is entitled within 2 months to challenge the notice in a court order, in which case the effectiveness of the notice is suspended until the date when the relevant court resolution enters into force.

8. Change of control over a subsoil user

8.1. Regulation by the Law

The current Law stipulates that participatory interest (shares), securities confirming title to shares or securities convertible to shares in the charter capital of:

(i) a subsoil user; or

(ii) a legal entity which (a) may directly and/or indirectly determine and/or influence decisions adopted by the subsoil user, provided (b) the principal activity of such legal entity user is connected to the subsoil use in Kazakhstan, -

are called "objects associated with the subsoil use right" (the "Objects").

Any transfer of the Objects is subject to the Ministry's consent (the "Consent") (and the waiver of the state's pre-emption right (the "Waiver") if the Objects relate to a Strategic Plot), save for a limited number of exceptions (including that no Consent is required if as a result of transaction an acquirer possesses less than 0.1% of the Objects (out of 100% of shares)).

Such regime results in the formal requirement to obtain the Consent even if 0.1 or more % of the Objects is transferred.

Failure to obtain the Consent entitles the Ministry to unilaterally terminate the relevant subsoil use contract. Furthermore, transactions with transfer of the Objects concluded without the Consent (when due) are considered as void from the moment of their execution from Kazakhstan law perspective.

8.2. Regulation by the Code

Article 30 of the Code sets out the definition of a strategic subsoil plot, which includes, inter alia, uranium deposits, subsoil plots at the Caspian Sea or with resources exceeding certain volume of minerals (the “Strategic Plot(s)”). The list of Strategic Plots is approved by the RoK Government.

Save for a contradicting clause of the Code analyzed in below section 8.3, the Code sets out that the Consent and the Waiver are required only for transactions with transfer of the Objects (in a limited meaning under the Code with exclusion of the provision regarding “provided the principal activity of such legal entity user is connected to the subsoil use in Kazakhstan”) related to Strategic Plots (the “Strategic Objects”), including issuance of Strategic Objects into circulation at a stock exchange or enforcement of the pledged Strategic Objects.

At that shares in legal entities being owners of the Strategic Objects circulating at a stock exchange are not acknowledged as Strategic Objects.

The Code also stipulates that organizations (i) participating as a strategic partner of a Kazakh national company in hydrocarbons sphere in direct negotiations with the Ministry with regard to granting a subsoil use right or (ii) admitted to participate in an auction on granting a hydrocarbons subsoil use right are acknowledged as subsoil users, and, accordingly, the above requirements apply to them.

Article 33.2 of the Code sets out 15 exceptions when no Consent and Waiver are required (including, inter alia, transfer of Strategic Objects circulating at a Kazakhstani or foreign stock exchange).

8.3. Contradicting clause

Article 33.2 of the Code contains a contradicting clause, whereunder no Consent is required if as a result of transaction a person acquires less 1% of the shares in the charter capital of a subsoil user and/or organization, which has a possibility to determine directly/indirectly decisions made by the subsoil user.

Apart from other provisions of the Code directly referring to Strategic Plots or Strategic Objects, there is no such reference in this provision.

Accordingly, the lawmaker should either add the above reference or, if this provision remains as it is, under the conservative approach, any transaction with transfer of 1 or more % of shares in the charter capital of a subsoil user and/or organization, which has a possibility to determine directly/indirectly decisions made by the subsoil user, will require the Consent (even if there is no relation to a Strategic Plot).

8.4. Obligation to notify the Ministry about change of control

The Code sets out the requirement that a subsoil user shall notify the Ministry about change of membership of persons and/or organizations having direct or indirect control over the subsoil user within 30 days from the date of such change.

“Direct control” means compliance with one of the following conditions:

- (i) possession of more than 25% of participation right (shares, securities confirming right of ownership to shares or convertible into shares) in an organization;
- (ii) possession of the right to vote by more than 25% of all votes in the supreme management body of the organization;
- (iii) receiving more than 25% of the distributable net income of a subsoil user; and/or
- (iv) possession of the right to determine decisions of another organization according to an agreement or by virtue of law.

“Indirect control” means a right of a person/organization to control another organization through a third organization (organizations), between which there is significant^[3] direct control.

8.5. Pledge of subsoil use right (its part)

The Code does not require obtaining the Consent for pledge of a subsoil use right (its part) or Strategic Objects. However, pledge of a subsoil use right (its part) is subject to and becomes effective only from the moment of its registration at the Ministry.

9. Restoration option for failure to obtain the Consent for transfer of Strategic Objects

As discussed above, transfer of Strategic Objects requires the Consent. According to the Enactment Law, the Ministry is entitled to unilaterally terminate the current subsoil user’s contract pertaining to a Strategic Plot if the Consent was not obtained. At that in case of such a violation, it shall be eliminated within the period not exceeding 1 year by restoration of the situation being before the violation. In case of impossibility of the restoration other actions on transfer of the relevant Strategic Objects shall be executed upon the Consent.

In case of elimination of the violation the subsoil user shall send to the Ministry documents evidencing the elimination within the above timeline.

In case of a failure to timely eliminate the violation, the Ministry unilaterally terminates the contract by prior 3-month written notice to the subsoil user.

10. Extension of exploration period

A current subsoil user is entitled to extend the exploration period of its exploration or combined exploration and production contract only if it discovers a mineral resources deposit, which exploration was set out by the contract.

11. Strategic Plot: extension of production or assignment

A current subsoil user is entitled to extend the term of its production contract at a Strategic Plot for more than 10 years or assign the subsoil use right over such plot to another person only if one of the following obligations is included into the contract:

- (i) to create a processing facility either on its own or by its subsidiary organization or by a joint venture;
- (ii) to make modernization or reconstruction of existing production facilities of the subsoil user;
- (iii) to make modernization or reconstruction of existing processing facilities;
- (iv) to provide the produced minerals for processing to processing enterprises (facilities) located on the territory of Kazakhstan;
or
- (v) to implement an investment project in accordance with the RoK Commercial Code or a project aimed at the social and economic development of the region either on its own, by its subsidiary organization or by a joint venture.

12. Suspension of validity period of exploration or production of hydrocarbons

If a subsoil user provides evidence of force-major circumstances, then validity period of a relevant exploration or production contract is suspended for the period of such circumstances (absence of funds or required GWS are not force-major circumstances).

If during exploration period a subsoil user discovered a gas or gas-condensate deposit, the validity period of its contract is suspended for the term required for construction of gas transportation infrastructure, but for not more than 5 years.

If during exploration period a subsoil user discovered a hydrocarbon deposit at a border area, the validity period of its contract may be suspended by the Ministry's decision for the period until a relevant intergovernmental agreement regulating the procedures of joint development of such deposit is signed.

13. Abandonment

At termination of a current subsoil user's contract, abandonment obligations shall be executed at the expenses of current subsoil users' abandonment funds according to and within the timeline set out by the Code.

14. Enlargement of production territory

Enlargement of a territory under a production contract belonging to a current subsoil user is allowed only for 50% maximum.

15. Potential tax changes

Together with enactment of the Code the authorities plan to enact a new Tax Code. According to presentation of the Minister of Energy dated 1 March 2017[4], the authorities plan:

(i) to rescind the commercial discovery bonus;

(ii) to eliminate tax borders between an exploration contract and a production contract. This will allow to deduct exploration costs at the expenses of another production contract and reduce expenses connected to income tax and excess profit tax;

(iii) to rescind subsoil users' special payments for deposits with the depth being more than 6000 meters and sea projects with the transfer to a financial result tax (according to the latest draft Tax Code, such subsoil users will be entitled instead of paying special payments and taxes to choose an alternative option to pay a financial result tax);

(iv) for new exploration contracts to rescind obligations on financing tuition of Kazakhstani personnel, research and development works, payments on social development of the region and historical costs. Such payments shall be made on a production stage.

We also note that unlike the current Article 30 (Guarantees of Subsoil User's Rights) of the Law, similar to it Article 19 (Stability of Subsoil Use Conditions) of the Code does not have stability carve-outs for amendments to taxes and customs regulations[5]. Accordingly, it might be the case that the authorities are considering an option of providing the stability of tax and customs regime for new subsoil users.

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[1]-<http://www.adilet.gov.kz/ru/articles/plan-zakonoproektnyh-rabot-pravitelstva-respubliki-kazahstan-na-2017-god> (Rus)

[2]-

<http://geology.gov.kz/images/stories/spravochnik/Перечень%20по%20углеводородному%20сырью%20на%201.01.2017%20г.%20по%20данным%20№2-ЛКУ.pdf> (Rus)

[3]-In previous version (February 2017) of the draft Code, there was a definition of “significant direct control” with the threshold being not 25% (as in “direct control”) but 50%. We are of the view this is a typo.

[4]-<http://energo.gov.kz/index.php?id=9928> (Rus)

[5]-We note the December 2016 version of the Code included stability carve-outs for amendments to taxation and customs regulation under the condition “unless otherwise set out by provisions of the mentioned RoK legislation”.

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