Energy Fact Sheet

PECOB'S ENERGY POLICY STUDIES

KAZAKHSTAN

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I. Overview

I/1 Key economic indicators

Population .... 15.68 millions
GDP .... 37.27 Billion 2000 USD
Energy production .... 148.19 MTOE
Energy consumption per capita........... 4.52 TOE per capita
Electricity consumption........................ 4,689 kWh per capita
CO2 emission per capita....................... 12.86 t of CO2 per capita

Source: IEA 2008

I/2 The Energy Mix

Kazakhstan is the largest State in Central Asia, a strategically crucial area for the extraction of hydrocarbon resources. This region has become the target of competition between major players, such as Russia, China and Iran.

Kazakhstan is particularly important for its oil proven reserves, estimated to be the world's 8th for capacity. For this reason, several Western as well as Chinese/Russian companies are involved in the extraction and exploration process.

Although Kazakhstan presents several gas fields, they may not be comparable with those of its neighbours such as Turkmenistan or Uzbekistan. The majority of these resources are devoted to export (especially with Russia and lately with China) .

Domestic energy consumption is almost entirely covered by the industrial sector, where coal and peat are the predominant resources implied. Nevertheless domestic consumption cover only a residual part of Kazakh's energy production, which is mainly directed toward export.

Kazakhstan's proven oil reserves amount to 3.6 billion tons, situated in three main oil fields, Kashagan, Karachaganak and Tengiz. Western companies are operating together with KazMunaiGaz (Kazakhstan's national oil company) in extracting and distributing these resources.

	Industry	Transport	Residential	Commercial and Public Services	Agriculture and Forestry	Fishing	Non-energy	Other	Production	Imports	Exports
	USE								CONSUMPTION		
Coal and Peat	8090	0	0	0	0	0	578	0	48837	577	-19190
Crude oil	0	0	0	0	0	0	3	0	70976	3203	-60373
Oil products	2950	4883	193	239	981	0	545	1739	0	2524	-4056
Gas	780	0	0	0	0	0	0	17446	27571	5198	-5231
Nuclear	0	0	0	0	0	0	0	0	0	0	0
Hydro	0	0	0	0	0	0	0	0	642	0	0
Geothermal, solar	0	0	0	0	0	0	0	0	0	0	0
Other renewables	0	0	0	0	0	0	0	164	164	0	0
Electricity	2842	202	639	0	594	0	0	1675	0	238	-213
Heat	4043	99	2009	0	0	0	0	4125	0	0	0
Total	18704	5185	2841	239	1575	0	1126	25150	148190	11740	-89063

Table 1: Kazakhstan Energy Mix:
Source: IEA, 2008

1000 Tons	Crude Oil	Natural Gas/Liquids	Liquefied Petroleum Gases	Motor Gasoline	Jet Kerosene	Other Kerosene	Gas/Diesel	Fuel Oil
Production	58646	12025	1342	2505	328	74	4566	3204
Imports	3187	0	24	1037	103	23	601	138
Exports	-48979	-11138	-1038	-155	-3	-1	110	-129
Domestic Supply	12854	887	350	3759	107	95	3654	2067
Transformation	12120	887	0	0	0	0	0	866
Oil Refineries	12072	887	0	0	0	0	0	0

Table 2: Kazakhstan's oil and gas sectors
Source: IEA 2008

Although gas resources are estimated to be considerable (1.9 trillion cubic meters) , their employment is limited by a lack of technological availability. This led to a flare of almost one third of these resources every year. Gas is mainly directed toward house consumption, even if the 2009 inauguration of a gas pipeline connecting Turkmenistan to China via Uzbekistan and Kazakhstan has opened new perspectives for the export of these resources.

The extraction and distribution of Kazakhstan hydrocarbons has historically been under Russian control, since the old pipeline infrastructures connecting its fields to the boarders are traditionally controlled by Russian Transneft company. Nevertheless, from the 90's onwards, new infrastructural projects permitted an increase in export diversification. The Baku-Tbilisi-Ceyhan pipeline project and the new Kazakh-Chinese oil pipeline led to an increase of production in order to satisfy new Western and Eastern outlets.

For what concerns the composition of 2010 oil export, over a total of 1450 mbpd, 950 are directed toward Russia through the Atyrau-Samara pipeline and the CPC (Caspian Pipeline Consortium) , 200 go to China through the Kazakh-

Picture 1: Net Export/Imports(-)
Source: own elaboration

stan-China pipeline built in 2009, and the final 300 are redirected to the BTC through the Transcaspian.

II. ENERGY LEGISLATION

II/1 General Legal Framework

In early 1991, two countries bordered on the Caspian: the USSR and Iran. At the end of the year, the countries bordering on its shores became five – Azerbaijan, Russia, Kazakhstan, Turkmenistan, and Iran. The Russian Federation and Iran had conducted side talks on the Caspian question ever since 1992. Russia began considering the Former Soviet Republics' opinion in October 1993, when a gathering was called in Astrakhan on the Russian side of the Caspian. Invitations were sent to Baku and Ashgabat.

In order to avoid being left out, in December, Kazakhstan agreed with a consortium of Western companies (Agip, British Gas, Statoil, Mobil, Shell, and Total) to conduct geological and geophysical explorations in what Nazarbayev considered to be the "Kazakh share" of the Caspian. This decision from Almaty was followed by a diplomatic note sent in April 1994 from the Russian Foreign Ministry to London. Moscow clearly stated that no Caspian project could be recognized without prior Russian approval.

As a matter of fact, Kazakhstan's position was outlined in July 1994, when Almaty proposed to establish a convention that would settle the question on the basis of the internationally recognized Law of the Sea (LoS) . This would have granted each state the right to enjoy three tiers of legal configurations (internal waters, territorial waters, and exclusive economic zone) , leaving fishing and navigation free for all. Later in 1994, the Russian Federation went on to present a proposal before the United Nations, rejecting the LoS framework and referring to the two key treaties with Iran, the 1921 Russo-Persian Treaty of Friendship and the 1940 Treaty of Commerce and Navigation.

Conversely, once Yevgenii Primakov was appointed Foreign Minister in Russia, he placed an interesting proposal on the table that unveiled the new foreign policy approach, which he personified. In November 1996, Primakov outlined the offer: the exclusive economic zone would cover as much as 45 miles off the coastline for each littoral state. He did not put any limit on business development in the region with the only condition of Russian public or private participation. Kazakh officials could do nothing but reject the plan, not least of all because of the ongoing involvement in Western-led exploration ventures. On the contrary, Turkmenistan and Iran lukewarmly signed a memorandum on cooperation to build on Primakov's proposal. To end their seemingly impossible quarrel, on July 6, 1998 in Moscow the top officials of Russia and Kazakhstan reached a bilateral agreement on what they considered "their" part of the Caspian. The fundamental concept they agreed upon was the "median line" subdivision, i.e. an imaginary line that is equidistant from both shores. The agreement reached in 1998 was followed by an "energy" pact, signed by Putin and Nazarbayev in 2002.

II/2 Subsoil Ownership

In Russia and Kazakhstan, as in many OECD countries, the state is the sole owner of subsoil resources and of the major part of oil produces by state-owned companies occupying monopolistic positions.

Since independence, Kazakhstan has striven in the direction of attracting foreign investments by building a solid body of investment legislation. In late 1994, a Law on Foreign Investments was passed, strengthening the accountability of the country by abiding to international legal standards. In addition, another legal milestone adopted in the early Nineties was the Law "Concerning Petroleum" (nr. 2350, June, 1995) , which established and regulated three forms of ventures (Joint ventures, Production Sharing Agreements and licenses, see below) . However, these provisions have been modified by new laws in the mid-2000s, therefore securing more government control over the Kazakhstan's subsoil use.

II/3 Forms of Ventures

The different forms of venture are important in order for the foreign companies to balance economic feasibility and the rule of law. The taxation system is a key variable that shows the state's approach towards revenues from the energy sector.

II/3/a Joint Ventures

As a general rule, which is usually followed, a foreign (often multinational) company teams up with a host country agent, sharing expertise and capital in exchange for local know-how in terms of rights and duties. Contract negotiations take place either between the foreign actor and the government or directly between the two industry subjects. The parties share ownership of the production and share the risk and reward of the venture in proportion to the capital contributed. The latter represents the case where the state loses its grip on sovereign risk, therefore opening the possibility of a re-negotiation in case of trouble during the development of operations.

II/3/b Licensing Contracts

A different scheme is provided by classic licensing contracts, which are long term concessions by the state to a private entity or group of companies that grant complete control to the licensee, even the ownership of the product. However, these kind of accords leave room for arbitrary state intervention. The complexity of the subsoil use licensing regime and the lack of legal certainty open the opportunity for the government to revoke licenses if the licensee fails to act in accordance with any of the significant terms of the agreement. The absence of further specification renders the licensing framework the riskiest for a company to engage with. High revenues might be completely offset by a capricious official act.

II/3/c Production Sharing Agreements

In order to contrast this type of too loose- or too heavy-handed frameworks, governments of countries well endowed with energy have crafted a scheme that allows them to enter the first and the last stages of a field's development, i.e. the administration of subsoil ownership and the production and distribution of the product: the Production Sharing Agreement (PSA) .

PSAs put the burden of financial and exploration risks on the company, while the government agrees to surrender claims on the revenues from the first stage of production. Once the company has recovered the financial equivalent of its exploration and operational expenditures, known as "cost oil", the government enters in the profit sharing at a typical rate of 80:20, while the other subject in the agreement starts paying taxes on its share of "profit oil". This is a scheme used mainly by developing countries and has been suggested as a World Bank model especially for post-Soviet transition economies.

Given these options, the Kazakh government has preferred to structure the legal framework for the exploitation of the fields with PSAs, which regulates 86% of Kazakhstan's oil output. Kazmunaigaz was entitled exclusive rights to carry out the agreements in lieu of the government.

Kazakhstan's regulatory pattern gradually abandoned PSAs. As though their actions showed legal ripeness and the conclusion of the precarious stage of the economic transition, Kazakh leaders began to downsize and undervalue the advantages of PSAs in order to shift from blind acquiescence towards foreign investors to a firmer control of the energy sector. With the modification of the PSA law in 2005, a provision was introduced (Law 68-III, article 5.1.2) that mandated a minimum participation for Kazmunaigaz, the state oil and gas company, of 50% in any new contract. Therefore, as of the enactment of the new Tax

Code in January 2009 (see the next section) , the PSA has been abolished as a type of subsoil contract. While still honoring PSAs registered before 2009, this provision represents a watershed in the Kazakh approach to the management of natural resources. It is evident that Astana regards the development phase of its energy sector to be complete and is now shifting interests in its economic policy.

II/4 Energy Taxation

The key elements of the Kazakh post-Soviet tax regulations were laid out in the 1995 comprehensive Presidential Decree "Concerning taxes and other obligatory payments to the budget". This provision distinguished two taxation profiles according to a residency classification. An important guarantee for investments was that taxes could not change throughout the life of a project, because they were not amendable *ex post*. It is noteworthy to highlight Kazakhstan's implementation of the Extractive Industries Transparency Initiative since 2005. This, in addition to the reliable taxation system, contributes to strengthening the investment framework, securing a stable climate for foreign companies, according to Kazakh officials in the United States.

The energy sector is regulated through standard direct (income, withholding on dividends, royalties) and indirect taxes (VAT, excises, customs duties) . The interesting feature is the amendment to the original tax code that exempts corporations from VAT in the case of geological exploration or prospecting operations. Since January 2009, the new Tax Code has lowered most direct and indirect tax rates and substituted royalties with the mineral extraction tax (MET) , which amounted to a 17% burden on Kazmunaigaz (the state-owned oil and gas holding) during its first year in effect.

However, the most recent developments in legal and fiscal policies on the energy sector have engendered mixed emotions on the part of foreign energy companies. On the one hand, the initial thrust for privatization and transparency, accompanied by Kazakhstan's notable hydrocarbon endowment, continues to be an incentive for multinational energy firms. On the other hand, there is a growing fear among business experts that Kazakhstan might tread the Russian path and wield state influence through institutional decisions that could jeopardize the firms' interests and render their investments uneconomic. For instance, the abolition of PSAs in 2009 has caused the termination of the related tax stability provisions in all new subsoil use contracts.

Moreover, old PSAs such as TengizChevrOil (TCO) and Karachaganak Petroleum Operating group (KPO) have been included in the payment of export duties after the rate hike of late 2010-early 2011.

II/5 Oil and Gas Industry

Privatization of the Kazakh oil and gas industry began at full pace in 1996. Since independence, Kazakh strategy has been resource-oriented, transforming its ownership structure from that of a Communist country to an oil boom economy. The objective was to utilize Western economic paradigms (rather than rentierist ones) in order to sustain the state budget. The sale of the stocks and tax revenues would greatly contribute to the economic transition of the newly independent state. As in Russia, the plan was to reallocate a small percentage to the workers, and then break the privatization process into two periods. During the first period, a controlling stake would be sold to a strategic investor to assure efficiency in the firm's economic performance. The second period would be dedicated to market bidding for the remaining shares. The basic legal principles were stated in the Presidential Decree of 23 December 1995 "On Privatization". For this purpose, during 1995 the state converted most of the oil and gas enterprises into Joint Stock Companies (JSCs) . This resembled Soviet-to-Russian transition, but the outcome was the opposite of Russia's large, state-owned, integrated enterprises (especially in the gas industry) .

During the first wave, foreign firms had the lion's share of the sale. Over 60% of known recoverable reserves were made available to foreign participation. However, in 1997, within the President's reorganization of the government, Nazarbayev's policy towards fast-track privatization of oil and gas changed. Former Oil Minister Nurlan Balgimbayev became the head of the brand new JSC Kazakhoil and continually stressed the need for accountability and creditability of new foreign bidders. In sum, as Richard Pomfret put it, Kazakhstan's privatization policy has encompassed all directions: during the first period, from below and from within, later from without, and finally, after some stricter legislative provisions, from above.

However, after 2000, Kazakhstan configured itself as the next Asian tiger. Significant GDP growth was accompanied by an equally decisive development of the energy sector, which allowed the government to balance the overall growth with accurate economic policies. Since 2004-2005, the oil sector has represented more than one third of export and one fifth of budget revenues, contributing to Kazakhstan's ranking as the recipient of the largest amount of FDI per capita among the former Soviet countries.

To avoid falling into the "oil curse" (also known as the "Dutch Disease") , president Nazarbayev had issued a decree in mid-August 2000 establishing the National Oil Fund, a stabilization fund modeled on the Norwegian one. The successful achievement of Norway in the management of wealth coming from natural resource exploitation was a guarantee for Kazakhstan in its efforts to channel the expansion of the sector. The fund receives royalties and surplus profits related to the sale of crude oil when its price exceeds the fixed cap (around 50 US dollars per barrel, recently modified to face the global crisis) . This works as a stabilizing mechanism, reducing economic dependence on unfavorable external factors. In mid-2009 the fund's assets amounted to 22 billion dollars, already discounted by some 5 billions by the Government as an anti-crisis investment program. Thus, the fund has been serving the purpose of a stabilizing feature for the Kazakh economy and has already been used in order to re-fuel the economy.

Heavily reliant on the success of the National Oil Fund, the Kazakh Government adopted a New Industrial Development Strategy in 2003 that aims to diversify the economy and ultimately to switch from heavy dependence on the extractive sector to a service and technology-based economy.

Another major event occurred with the creation of a vertically integrated oil and gas joint stock company. In 2002, Kazakoil, Kaztransoil, Kazakgaz and Kaztransgaz merged into Kazmunaigaz (KMG) , a new vertically integrated JSC often acting in lieu of the government when negotiating energy deals. It adhered to the 1998 statement by Nazarbayev, calling for the conservation of the oil and gas transportation system against falling into private hands. The company is controlled by Timur Kulibayev, CEO of KMG, son-in-law of the president and vice-chairman of the Samruk-Kazyna fund, which controls 100% of KMG.

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