A NEW AGE OF OIL AND GAS INVESTMENT IN KAZAKHSTAN

by Anthony Mahon
Partner, Caspian Energy and Resources Leader
Deloitte Kazakhstan

The past five years have seen unprecedented turbulence impact the global oil and gas industry.

This turbulence, in supply terms, has been brought about as new sources of production flowed from US shale and tight oil and gas formations, as Iranian sanctions lifted, as OPEC maintained production volumes and as geopolitical, economic and environmental shocks in North America, the Middle East and Africa operated so as to boost and restrict global oil and gas supplies.

From a demand perspective, the slowing of China's economy over recent years has meant that the reduced demand from the Asian superpower (allied to sluggish global growth and economic activity) has combined with the associated supply side pressures impacting the market to bring about an unprecedented slump in global oil and gas prices.

Notwithstanding Kazakhstan's widely publicized strategies targeting economic diversification in the country, the fact remains that income from mineral resources – and, in particular, oil and gas resources – shall represent a dominant proportion of State revenues for the foreseeable future.

Drill-down into history

Kazakhstan's post-Soviet oil and gas landscape was made up by a combination of post-Soviet fields transferred into private (local and international) ownership and new joint ventures between the national oil and gas company (and its predecessor organizations) and supermajor oil and gas groups making new, major plays in Kazakhstan.

Throughout the decade following the new Millennium, global prices trended steadily upwards to a peak in excess of $145/barrel until a sharp decline precipitated by the global economic crisis began in late 2008, reducing prices to around $30/barrel.

In 2009, following this epic price shock, Kazakhstan revisited its subsurface use frameworks so as to replace the prevailing PSA-based taxation regime with the current Excess Profits-based system as now set out in the Tax Code, Petroleum Law and Subsurface Use Law.

In addition to the change in the mode of taxation applied between the two types of agreement, the key associated differentiator between these two bases of taxation was elimination of the concept of tax stability enshrined in the original Production Sharing Agreements concluded by the Government of Kazakhstan (and, retained in only a limited number of cases after 2009).

Whilst this shift to the current basis of taxation was undoubtedly directed at enabling the State to participate in higher returns in times of increased global prices, the elimination of tax stability also doubtless reflected the State's confidence as to the attractiveness of its resource reservoirs as available global reserves moved towards a perceived downward curve of increasing scarcity.

Since 2009, however, the accepted perspectives regarding global reserve stocks have dramatically shifted as the US shale industry and other global sources of unconventional oil and gas supply have been both brought online and been made economically viable as new extraction technologies have evolved.

The altered landscape in terms of potential destinations for global international oil and gas investments has profound impacts for the future of the oil and gas industry in Kazakhstan and is something that should be tackled in a fundamental and far-reaching manner.

Core principles of oil and gas taxation

Oil and gas companies, like all other rational investors, have the objective of maximizing profits and, when considering where to invest capital, consider the stability, clarity and predictability of the local fiscal, legal and regulatory environment when considering whether or not to invest in a particular jurisdiction.

Oil and gas fiscal frameworks invariably have four key characteristics:

- The resource base in question is not infinite and, therefore, the State needs to be adequately compensated for the depletion of these resources;
- Substantial up-front investments are needed to explore for, develop and extract these resources;
- Significant project risks exist in terms of geological, pricing, political and technical factors which all operate so as to impact upon the "risk premium" attached to any particular project or jurisdiction;
- The revenues from extractive industries often form a dominant proportion of State income and, accordingly, amendments to fiscal regulations governing these industries (or revenues flowing from such regulations) can have an exponential impact upon public finances.

It is therefore crucial that the fiscal terms applied to the extractive industries appropriately allocate financial risks and benefits between both sovereign governments and private companies.

There are clearly always conceptual conflicts between oil and gas companies and the State regarding the appropriate division of risk and reward from a petroleum project as each party seeks to maximize rewards and shift as much risk as possible to the other party. Nevertheless, the right choice of fiscal regime can improve the trade-off between each party's interests—a small sacrifice from one side may be constitute a significant gain for the other.

Oil and gas agreements and the associated fiscal rules establish the "price" of the resource in terms of the bonuses, royalties, taxes or other payments the investor will make to the Government over the life of the project. Designing fiscal arrangements that encourage a stable fiscal environment and efficient resource development maximizes the overall total realizable value of the revenues to be divided.

Insofar as returns are eroded by excessive taxation especially in times of price volatility (and if the fiscal regime taxes primarily on the basis of production or turnover rather than profits or investors are not suitably compensated for the up-front investment risks) this will, in turn, significantly inhibit the inward flow of new international oil and gas investment.

This can be seen to have been the case in Kazakhstan over the past 3-4 years where (with the exception of the entry of new Chinese investment or additional investments in subsurface projects with stabilized fiscal regimes) there has been a paucity of significant new investments made by international oil and gas companies.

Turning on the tap of new investment into Kazakhstan

On the premise that Kazakhstan continues to retain reservoirs and potential projects that are of interest to international oil and gas companies the question to address is "what must the State do in order to facilitate the successful future entry into the market of these investment Dollars?" As outlined previously, international oil and gas investors are seeking to maximize returns from their investments by understanding, evaluating and managing the multi-faceted risks entailed in such investments.

Oil & gas projects are not only capital intensive but also involve investment which runs over an extended timeline. Any oil and gas company investing in a foreign jurisdiction also becomes exponentially exposed to risks once an investment is committed because an exit from this point is not possible without triggering significant adverse financial consequences. Although a level of fiscal uncertainty is universally present in oil and gas projects, international oil companies are particularly concerned when investing in countries where the perception exists that the fiscal legislation is in constant flux as this significantly reduces a potential investor's ability to forecast future expected cash flows.

Investors faced with this perceived elevated level of fiscal risk (as a consequence of a financial system and tax regime that is subject to frequent and material changes) reduce the value placed

on future income streams (as higher discount rates are used when evaluating likely returns from investments) in order to compensate for exposure to increased risks. This is one of the primary factors inhibiting the entry of new significant oil and gas investment.

It should also be clearly recognized that, in terms of its quest to attract new international oil and gas investment, Kazakhstan is in competition for such capital with other nations and projects that do not carry the same level of "risk premium" and, consequently, this renders investment in Kazakhstan comparatively less attractive or viable.

Striking an attractive balance

Host governments often need the technical and financial capabilities of international oil companies (in addition to their willingness to bear "downside risk") in order to successfully develop and exploit national mineral resources. However, the State also often wishes to retain an ability to capture upside rewards when commodity prices are high via increases in government take and an assertion of control over their own natural resources.

In the prevailing environment of sustained and lower outlook for oil and gas pricing, it is also important to create a fiscal environment that offers investors an opportunity to make profits and positive investment returns at low prices but also provides scope for both investors and State to generate acceptable and equitable returns as commodity prices begin to rise. It is possible to focus on a cluster of available fiscal concepts via which these objectives may be successfully achieved, namely:

• Stabilization; and

• Progressivity and a focus on taxing profit or project returns rather than taxation of extraction and volumes.

A stabilization clause is a contractual risk-mitigating device to try to protect investments from variations in the fiscal, legal and regulatory environment and is a part of a framework of investor protection which also combines local laws and international treaties. From a government perspective, stabilization can be interpreted as a relatively attractive and, inexpensive mechanism via which investor risk might be mitigated. In its most basic form (ie. where applicable legislation is merely “frozen” at a particular point in time and remains constant through the duration of the contract in question), stabilization could be seen to operate so as to potentially limit the government’s future fiscal flexibility.

However, such adverse potential impacts are not certain to arise as there are several ways in which stabilization could be implemented that retain the ability for the State to amend applicable taxation policy to align with future economic goals (albeit with the mutual consent of the investors concerned). Fiscal regimes are also capable of being retained in a stable form (ie. would come under less pressure to be amended/reformed) to the extent that they contain progressive factors that provide the State with an increasing share of returns as project profitability increases.

This progressivity could be achieved using a variety of mechanisms that might include progressive income or profits taxation, windfall and excess profits taxes and dynamic-rate royalty structures., as opposed to taxing the mere activity of extraction that can make investment uneconomic.

The underlying concept to all of the above is that a successful oil and gas fiscal regime should provide profit incentives at a wide range of oil prices in order for the companies to continue to produce and invest. Currently, the Ministry of National Economy is tasked with a major project to produce a new Combined Tax and Customs Code and one of the stated objectives is an improvement in the Subsurface Use Taxation regime in Kazakhstan.

The changes to the way oil and gas operations are taxed in Kazakhstan should be fundamental and far-reaching in order for Kazakhstan to attract the investment needed to secure the country’s future prosperity. To that end, it is crucial that the stakeholder community is fully consulted and engaged in this tax reform project in order to arrive at a fiscal framework that brings benefits for both State and investors alike in order to continue to attract badly needed new subsurface investment in Kazakhstan.