

THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY  
RICE UNIVERSITY

**KAZMUNAIGAZ:  
KAZAKHSTAN'S NATIONAL OIL AND GAS COMPANY**

BY

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PREPARED IN CONJUNCTION WITH AN ENERGY STUDY SPONSORED BY  
THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY  
AND  
JAPAN PETROLEUM ENERGY CENTER

RICE UNIVERSITY – MARCH 2007

THIS PAPER WAS WRITTEN BY A RESEARCHER (OR RESEARCHERS) WHO PARTICIPATED IN THE JOINT BAKER INSTITUTE/JAPAN PETROLEUM ENERGY CENTER POLICY REPORT, *THE CHANGING ROLE OF NATIONAL OIL COMPANIES IN INTERNATIONAL ENERGY MARKETS*. WHEREVER FEASIBLE, THIS PAPER HAS BEEN REVIEWED BY OUTSIDE EXPERTS BEFORE RELEASE. HOWEVER, THE RESEARCH AND THE VIEWS EXPRESSED WITHIN ARE THOSE OF THE INDIVIDUAL RESEARCHER(S) AND DO NOT NECESSARILY REPRESENT THE VIEWS OF THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY NOR THOSE OF THE JAPAN PETROLEUM ENERGY CENTER.

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## ABOUT THE POLICY REPORT

### *THE CHANGING ROLE OF NATIONAL OIL COMPANIES IN INTERNATIONAL ENERGY MARKETS*

Of world proven oil reserves of 1,148 billion barrels, approximately 77% of these resources are under the control of national oil companies (NOCs) with no equity participation by foreign, international oil companies. The Western international oil companies now control less than 10% of the world's oil and gas resource base. In terms of current world oil production, NOCs also dominate. Of the top 20 oil producing companies in the world, 14 are NOCs or newly privatized NOCs. However, many of the Western major oil companies continue to achieve a dramatically higher return on capital than NOCs of similar size and operations.

Many NOCs are in the process of reevaluating and adjusting business strategies, with substantial consequences for international oil and gas markets. Several NOCs have increasingly been jockeying for strategic resources in the Middle East, Eurasia, and Africa, in some cases knocking the Western majors out of important resource development plays. Often these emerging NOCs have close and interlocking relationships with their national governments, with geopolitical and strategic aims factored into foreign investments rather than purely commercial considerations. At home, these emerging NOCs fulfill important social and economic functions that compete for capital budgets that might otherwise be spent on more commercial reserve replacement and production activities.

The Baker Institute Policy Report on NOCs focuses on the changing strategies and behavior of NOCs and the impact NOC activities will have on the future supply, security, and pricing of oil. The goals, strategies, and behaviors of NOCs have changed over time. Understanding this transformation is important to understanding the future organization and operation of the international energy industry.

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## **ACKNOWLEDGEMENTS**

The James A. Baker III Institute for Public Policy would like to thank Japan Petroleum Energy Center and the sponsors of the Baker Institute Energy Forum for their generous support in making this project possible.

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# **KAZMUNAIGAZ:**

## **KAZAKHSTAN'S NATIONAL OIL AND GAS COMPANY**

Martha Brill Olcott, Carnegie Endowment for International Peace

### **AN OVERVIEW OF THE DOCUMENT**

The size of Kazakhstan's oil and gas reserves alone make Kazakhstan's national oil company, Kazmunaigaz (KMG), a worthy inclusion in any study of national oil companies. Kazakhstan's proven oil reserves are estimated between 9 billion and 17.6 billion barrels, including both onshore and offshore fields,<sup>1</sup> making it a potential producer of considerable influence. When Kazakhstan's major new projects reach full production (probably in 2015), it hopes to produce at least 3 million barrels of oil a day, which would make it a larger producer than Norway, and just behind Mexico and Iran. Even today Kazakhstan is an oil producer of consequence, producing 1.29 million barrels a day.<sup>2</sup> And virtually

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<sup>1</sup> "An Energy Overview of the Republic of Kazakhstan," US Department of Energy, [http://www.fe.doe.gov/international/Russia\\_and\\_Central\\_Asia/kazkover.html#Oil](http://www.fe.doe.gov/international/Russia_and_Central_Asia/kazkover.html#Oil).

<sup>2</sup> Energy Information Administration. "Kazakhstan." *Country Analysis Briefs*, 2006. Available online at <http://www.eia.doe.gov/emeu/cabs/Kazakhstan/Oil.html>.

anyone interested in investing in Kazakhstan is forced to work, in one form or another, with NC KMG.

NC KMG is also worth attention by those interested in the changing structure of the international oil industry. The company is very much a work in progress; one of the world's youngest national oil companies, it could turn into something of a model for other evolving national oil and gas countries, especially those in the former U.S.S.R., where a significant portion of the world's untapped oil and gas reserves are found.

KMG has some features in common with other NOC's formed in post-Soviet states, such as Russia, Azerbaijan, and Turkmenistan. But the Kazakh government has defined a much more aggressive developmental mission for NC KMG than has the Azerbaijani government for SOCAR, and certainly than the Niyazov government did for the various iterations of its national oil and gas companies. Unlike in Russia, where there are two NOCs Rosneft and Gazprom, with sometimes competing interests, Kazakhstan has opted to consolidate its holdings in a single company. Nonetheless, NC KMG has features in common with both Gazprom and Rosneft. Its degree of vertical integration resembles that of Gazprom. Rosneft, meanwhile, while lacking the same transportation and refining capacity of KMG or Gazprom, shares another equally important similarity with the Kazakh Company: both are seeking to introduce western management styles in order to create international investor confidence. Yet one very large difference remains between these two companies. Unlike Rosneft, whose chief oil producing asset is Yuganskneftegaz, which was bought at auction after seizure from Yukos,<sup>3</sup> virtually all of NC KMG's assets were obtained in a pretty straight forward fashion. They were either

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<sup>3</sup> Peter Fin, "Russian Oil Firm Buys Mysterious Bid Winner," *Washington Post*, December, 23 2004, A01.

acquired by purchase or by the transfer of a state held license to the company (directly or by the consolidation of smaller state-owned companies).

NC KMG is more likely to become a model for other post-Soviet NOC's than any other company, in large part because of its development strategy is both more forward looking and better articulated than that of its counterparts. The stated intent of both the Kazakh government and of KMG is that the company will devolve into a largely publicly held corporation, with the government insuring the protection of its interests through the voting of its shares by a larger holding company, Samruk—which's name is the Kazakh translation of the golden phoenix—created in 2006.

For now the relationship between KMG and the government of Kazakhstan is a very close one, as is the relationship between the family of the president of Kazakhstan, Nursultan Nazarbayev, and the country's oil industry. Those in key positions throughout the oil industry and a government, including the various ministries and executive level positions associated directly with the oil industry, understand the challenge that reform of the industry presents. They all realize that KMG needs to be transformed into an independent and transparent company within the remaining years of President Nazarbayev's term in office, which ends in 2013—a company which no longer serves as an indirect instrument of foreign policy or as a source of domestic graft.

As this paper explains, it is as yet unclear as to whether they will meet this challenge. Kazakhstan still faces the task of creating sustained investor confidence. The Kazakh government's treatment of international oil companies (IOCs) will partly influence the level of this confidence. Virtually every company of any importance has some activity in the country. Success will also depend upon the evolution of NC KMG itself—that

is, on whether it introduces full transparency in all of its upstream, downstream and associated activities and on whether it helps foster an atmosphere of competition in the service sectors that are associated with its primary operations.

The company will need to decide whether it intends to remain a production company, or to simply be a stakeholder in all of the country's major exploitation projects, as well as the major transit partner and a dominant player in Kazakhstan's downstream market. Whatever decision the company makes it is likely to still need to divest at least some of its assets, and become more focused in its acquisition of assets. Without this winnowing NC KMG will not maximize the value of their assets. They also must turn the company into a reliable partner for other investors in the country. This requires the completion of the political reform process within Kazakhstan, to provide a better articulation of the rights of investors, and better legal protection to respond to those situations in which investors believe their rights have been violated. Achieving these goals will strengthen NC KMG's own position in the international oil industry, and open new foreign upstream and downstream options to it—one of the stated goals of the company.

## **KAZAKHSTAN'S AMBITIONS**

Kazakhstan's president Nursultan Nazarbayev has pledged that his country will rank among the 50 "most competitive" countries in the world by 2015, a statement he made during his 2005 inaugural address and then elaborated upon in his 2006 address to the nation.<sup>4</sup> Its citizens already have the second highest per capita GDP in the FSU, surpassed only by Russia. The country's GDP has grown by at least 9.4 percent per annum

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<sup>4</sup> See Nursultan Nazarbayev, President of Kazakhstan. *Kazakhstan's strategy of joining the world's 50 most competitive countries: Address by the President of Kazakhstan to the People of Kazakhstan, March 1, 2006*; available online at <http://www.kazakhstanembassy.org.uk/cgi-bin/index/256>.

in recent years (with a high of 9.7 percent in 2005), and is expected to grow by a similar rate in 2007 and 2008.<sup>5</sup>

Kazakhstan has benefited from high oil prices, and from continued strong international interest in investment in its oil and gas industries, because, according to most economic and political indicators, it is the most stable environment for investment in the region. The country has the most stable currency in Central Asia and in the CIS more generally. Kazakhstan's tenge is already for all intents and purpose a fully convertible currency, with official account convertibility slated to be introduced in 2007. Its banking system is the strongest in the region, and Almaty is likely to emerge as Central Asia's financial center. The country's banks are also helping spur the development of a middle class, offering individual as well as commercial credit.

The country also has a favourable trade balance—although depending upon fluctuations in international oil prices, small trade deficits remain a relatively constant risk, as the country is still heavily dependent upon imports to sustain its economy. High oil prices have also helped the country balance its budget, since 2005, and the trade deficit in 2004 was only 0.2 percent of the GDP.<sup>6</sup>

Investment in hydrocarbons and oil and gas exports drive the country's economy, and they represent 62 percent of all export earnings.<sup>7</sup> Other sectors of the economy, though, are growing rapidly, including small financial services and telecommunications, the value of whose output increased 41.4 percent and 21.7 percent respectively in the first three quarters of 2006, and construction by 35.2 percent, driven in part by the enormous

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<sup>5</sup> Economist Intelligence Unit, *Country Profile 2006 Kazakhstan* (London: The Economist Intelligence Unit Ltd.), 2006, 3-4.

<sup>6</sup> EIU, *Kazakhstan*, 18.

<sup>7</sup> *Ibid*, 34.

building boom around the country's new capital (since 1997) city, Astana. While only making a small dent in the country's GDP, the growth of these sectors are creating new jobs, with unemployment down to just over 8 percent, and the development of a new middle class.<sup>8</sup>

Heavy industry and agriculture, the two major sectors of the Soviet-era economy remain a problem. While industrial output increased by 6.8 percent in the same period, the performance of this sector remains a problem for the government, as is agriculture. In the case of industry, the government has been criticized for an industrial development plan which continues to try and resuscitate the Soviet-era heavy industry.<sup>9</sup> The problem in agriculture, seems to be one of timing; the comprehensive and controversial agricultural reform introduced in 2003,<sup>10</sup> came too late for many farmers, after a decade of poor performance most former state farmers and collective farmers had little access to modern equipment or capital to acquire it, opening the door for those with sufficient capital to buy up large holdings, but offering them little economic incentive to develop them.

But obviously Kazakhstan has quite a ways to go, before meeting the ambitious goals that this new nation's first president has set out for it. President Nazarbayev, whose current term in office runs through 2012, does not believe that his country will meet its goals without strong government intervention in the economy, but the question remains, are they harnessing it in the most effective way.

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<sup>8</sup>Ibid, 28-30.

<sup>9</sup> For an overview of Kazakhstan development strategy see Nursultan Nazarbayev. President of Kazakhstan. *Kazakhstan-2030: Message of the President of the country to the people of Kazakhstan*; available online at [http://www.akorda.kz/page.php?page\\_id=135&lang=2](http://www.akorda.kz/page.php?page_id=135&lang=2).

<sup>10</sup> Code of the Republic of Kazakhstan, "Land Code of the Republic of Kazakhstan" of 20 June 2003. Available online at <http://www.pavlodar.com/zakon/?dok=02847&ogl=all>.

## KMG'S ORIGINS, ASSETS, AND RESERVES <sup>11</sup>

One thing is certain, harnessing the country's fossil fuel assets is key to any developmental strategy. President Nazarbayev has chosen to use oil and gas to spur economic development in two separate ways, both through the development of a National Fund, which is investing the state's income from oil and gas, as well as other key resources, into a fund that is loosely modelled after Norway's national oil fund.

This fund, created in 2001, is currently estimated to be worth \$14.1 billion, and is designed to provide long-term support for Kazakhstan's budget and compensate for uneven earnings caused by fluctuations in the global oil and gas market. It is a blue chip fund, of all foreign held securities, administered by Kazakhstan Ministry of Finance.<sup>12</sup>

The other half of the equation is the creation of a strong national oil and gas company, which is to have a dominating position in the country's hydrocarbon sector. To this end, the Joint-Stock Company KazMunaiGaz National Company was founded pursuant to Decree of the President of the Republic of Kazakhstan No. 811 as of 20 February 2002 through the merger of CJSC National Oil Company KazakhOil and Closed Joint-Stock Company NC Oil and Gas Transportation.

The opening up of Kazakhstan's industry after independence in 1991 brought in many foreign investors that helped buoy the industry. These investors signed PSAs with NC KMG's predecessor KazakhOil, but the production companies EMG (EmbaMunai-gas) and UMG (UzenMunaigaz), the major assets of KazMunaigaz Exploration and Production (KMG E and P), were not transferred to KazakhOil until 1997. By this point in

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<sup>11</sup> A chart of KMG's structure is included in Appendix IX.

<sup>12</sup> Ministry of Finance of the Republic of Kazakhstan, "National Oil Fund" *Ministry of Finance Website*, <http://www.nationalfund.kz/index.php?uin=1120634759&lang=rus>.

time some 2.1 percent of the voting shares of EMG and UMG were held by their employees and managers, who purchased them during the privatization auctions of 1993.

On March 16, 2004 the Company was renamed Joint Stock Company KazMunai-Gaz National Company. The Company was created with the aim of comprehensive development of the Republic's petroleum industry to ensure rational and efficient operation of hydrocarbons, which in turn, will contribute to social and economic development of Kazakhstan and its successful integration into the world economy.<sup>13</sup> The formal organization of NC KMG into a joint stock company also created possibilities for broadening ownership.

NC KMG was created with the aim of achieving a variety of strategic objectives, including the improvement of the financial and economic parameters of the company, adding to its hydrocarbon reserves, and increasing its production.

It was intended to do this through the reduction of expenses and increasing the net money flow, by increasing the efficiency of capital investments, to increase reserves through the exploration of new blocks and expanded exploration of existing ones, the maximizing their shares in existing enterprises. They were also to increase the economic benefit to the state from large oil and gas projects in which they were partners, through the development of transport opportunities available to Kazakhstan, and by assisting the development of petrochemical enterprises within Kazakhstan. They were further charged with increasing the share of domestically produced goods, works and services supporting the country's large oil and gas projects, and by helping increase the number of Kazakhstani staff directly engaged in these projects.

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<sup>13</sup> KazMunaigaz (KMG), "Company History and Mission," *KazMunaiGaz website*, <http://www.kmg.kz/main.php?page=inc/posted&mid=4&showm=3&type=men>.

JSC “NC KazMunaiGaz” is the third largest oil producer in Kazakhstan, and has a minority stake in virtually all major oil and gas projects in the country and a controlling stake in most of the projects initiated since 2000. The company and its subsidiaries employ over thirty four thousand employees, and reported an income of \$4.8 billion dollars in 2005, from its commercial activities.<sup>14</sup> KMG controls some twenty-five companies.<sup>15</sup>

### *KMG’s Oil and Gas Reserves*

#### KMG Exploration and Production

JSC KMG Exploration and Production (KMG E and P) is the most valuable asset of KMG, as it is the source of the majority of its income. Over the past eighteen months it has been being prepared for an international public offering, which was made in the beginning of October, in which some 23 million shares of common stock were being offered, just over 5 million of which would be offered in the form of GDR’s each representing one sixth of a share.<sup>16</sup> The shares are being traded on the Kazakh stock exchange, and the GDR’s through the London Stock Exchange, with the offering presented by ABN AMRO Rothschild, Credit Suisse Securities (Europe) Ltd., and Merrill Lynch International. It is the first foreign offering of KMG stock. Following the completion of the offering NC KMG will hold 60.1 percent of the shares of the company.<sup>17</sup>

Slightly under one third of KMG’s assets are held by KMG Exploration and Production, which controls the Uzen and Emba oil and gas fields, for which it is the operat-

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<sup>14</sup> KazMunaiGaz, “Financial Information,” *KazMunaiGaz Website*, <http://www.kmg.kz/index.cfm?tid=28>.

<sup>15</sup> KazMunaiGaz, “Structure of Assets,” *KazMunaiGaz Website*, <http://www.kmg.kz/index.cfm?tid=22>.

<sup>16</sup> London Stock Exchange (LSE), “IPO Prosepctus for JSC KazMunaiGaz Exploration and Production,” London Stock Exchange, 29 September 2006. From her e forward, cited a LSE, *KMG EP IPO*, xx.

<sup>17</sup> At the time of the offering shares of E&P sold for about \$15, and peaked at about \$23 dollars at the beginning of January. As of this writing, shares in the company are selling at about \$19.50. For information on the performance of E&P’s stocks see London Stock Exchange, “JSC KMG GDR,” *LSE Website*, <http://www.londonstockexchange.com/engb/pricesnews/prices/system/detailedprices.htm?sym=US48666V2043USUSDIOB%20B1FKV75KMG>.

ing company. KMG Exploration and Production is the most valuable income producer of the KMG companies, controlling most of the country's valuable on-shore oil reserves, excluding TengizChevroil (TCO).

KMG E and P shares the same goals as NC KMG. It seeks to increase the company's overall production and replace the company's reserves through the acquisition of assets that are already under production, through increasing production of its existing assets and through exploration and *development* of "green field" projects.

Given that the Emba (EMG) and Uzen (UMG) fields are "mature," and so KMG E and P is focusing on trying to develop new wells, extend well-life through the application of electric rotary and screw pumps as well as improving the quality of oil well tubing, to do well work-overs and introduce or improve various secondary recovery methods. The Uzen field<sup>18</sup> and several of the large EMG fields have highly paraffinic oil within shallow, low permeability formations, and oil from the EMG fields also tend to have a high water content (water cut), making extraction difficult. The management of KMG E and P are also committed to divert all non-core and ancillary businesses, and to bring their operation up to international environmental and labour safety standards.<sup>19</sup>

The total reserves of KMG EP are 1.52 billion barrels of oil, and 16.3 billion cubic meters of gas and 12.7 m barrels of gas condensate reserves.<sup>20</sup> KMG EP's unaudited

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<sup>18</sup> The Uzen field is also undergoing a major rehabilitation project, begun in 1997, which is partially funded through a \$151 million loan from EBRD. LSE, *KMG EP IPO*, 65.

<sup>19</sup> Ibid, 10.

<sup>19</sup> Martha Brill Olcott. *Central Asia's Second Chance*.(Washington, DC: Carnegie Endowment for International Peace, 2005).

<sup>20</sup> These numbers are based on Kazakh methodology for estimating reserves. KMG EP uses both Kazakh methods and international standards established by the SPE and WPC for calculating reserves. EP is obliged for government reporting reasons to continue to use the Kazakh standards. It has, however, contracts with an international oil consultancy, GCA, to calculate it reserves using international standards. For more information on the difference between these standard consult LSE, *KMG EP*, p.3 and p. 21.

assets as of May, 2006 were valued at \$3,515,908,000.<sup>21</sup> In 2005 production at the UMG and EMG fields was 132,7000 bopd and 55.3000 bopd respectively and UMG fields produced 812.1 million cubic meters of gas and gas condensate production was approximately 502 bcpd.<sup>22</sup> Recent income statements from KMG E and P are found in Appendix VI.

The company believes that it has enough reserves to last until the end of the contract period of its major deposits (which will expire 2015-2024). The estimated reserve life of the KMG E and P's reserves is 22 years at the 2005 daily production rate of 188 thousand bcpd.<sup>23</sup>

The proceeds of the global public offering will be used to pay for the acquisition of NC KMG's fifty percent share of KazGerMunai and 33 percent share of PetroKazakhstan, assets which are described below.

#### Other NC KMG Oil and Gas Assets

The companies other reserves are all held in cooperation with foreign partners, with full details of the consortia making up these projects found in Appendix II of this paper. These are all projects being developed under production sharing agreements signed by the Kazakh government. KMG has a twenty percent interest in Tengizchevroil project, which has 9 billion barrels of oil. Chevron was first brought in to explore and exploit the Tengiz field in the 1980s, and renegotiating the project was one of the first challenges facing the young Kazakh government after independence. KMG has 8.3 percent of the recoverable reserves at Kashagan, which are estimated at between 9 and 13 billion barrels. Initially the Kazakh government held 15 percent of this vast off-shore Caspian

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<sup>21</sup>These figures are for the end of 2005. LSE, *KMG EP IPO*, 9.

<sup>22</sup> Ibid, 12.

<sup>23</sup> Ibid, 19.

field, considered by many to be the country's prize deposit. The government sold off its share (approximately 1/7 of the project) in the aftermath of the 1998 financial crises, when the Russian economic melt-down in particular left the Kazakhs with a serious financial deficit. The \$500 million received allowed the Kazakhs to meet a good part of their wage and pension arrears, and so avoid a major social crisis.<sup>24</sup>

Unexpectedly high international oil prices helped speed the Kazakh economic recovery, and so in 2004 for when British Gas put their 16.7 percent stake up for sale, the KMG took advantage of the opportunity to purchase half of the available stake. Their purchase though, only came after the Kashagan consortium members refused the offer of \$615 million by the Chinese oil companies CNOC and Sinopec, a bid which was rumoured to have enjoyed the support of the Kazakh government.<sup>25</sup>

Before the consortium members could look for another buyer for this stake, or absorb the offered share of Kashagan themselves, the Kazakh legislature passed new laws governing the sale of strategic oil and gas deposits, which gave the NC KMG first refusal on all new offerings, and which mandated that the Kazakh's hold a fifty percent share in any new sales of strategic offerings. The existing consortia were not exempted from the resale provisions.

NC KMG also holds a fifty percent stake in Kazgermunai, with 100 million barrels of reserves. After the KMG E and P offering is completed they will have first refusal on the purchase of this asset, which they intend to buy.<sup>26</sup>

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<sup>24</sup> Martha Brill Olcott. *Central Asia's Second Chance*. (Washington, DC: Carnegie Endowment for International Peace, 2005): 90.

<sup>25</sup> Olcott, *Second Chance*: 90-91.

<sup>26</sup> LSE, *KMG EP IPO*, 14.

KMG has a controlling interest (51 percent) in Kazakhturkmunai LLP, a joint venture with the Turkish national oil company. This project controls five oil fields currently being explored (West Elemes, North-eastern Saztobe, South-eastern Saztobe, Sourth Karatobe and Lakybai, fields with high-quality oil, with low levels of contamination of resins and other additives. The period of joint production for this project began in January 2004.<sup>27</sup>

In addition, it controls and a fifty percent stake in Kurmangazy, with a reserve of 2.2-2.8 million barrels of oil. This latter project is in partnership with Russia's Rosneft, and is currently behind schedule due to a number of technical difficulties, and a disappointing result from recent drilling, where the well proved dry.<sup>28</sup> This has lead to rumors that that Total might be brought into the project.<sup>29</sup>

NC KMG also holds a 73 percent stake in Zhambyl, with 1.26 billion barrels, and a 25 percent stake at Zhemchuziny (Pearl Blocks), with 733 million barrels. In addition there are currently negotiations underway with interested foreign partners for the sale of stakes to Satpayev (1.85 billion barrels reserve), the off-shore Caspian "N" block (4.65 million barrels), Isatai (1.75 million barrels), Darkhan (11 billion barrels), and for the deposit at Abai (2.8 billion barrels).<sup>30</sup>

In addition KMG controls JSC "KazakhstanCaspian Shelf," which supervises the exploration of perspective oil blocks in Kazakhstan's part of the Caspian Sea, as well as on shore.

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<sup>27</sup> Kazenergy. "Oil and Gas in Kazakhstan," slideshow presentation at the Carnegie Endowment for International Peace, January 14, 2006.

<sup>28</sup> Information about the first well drilled at Kaurmangazy turning up dry was first published in Russian news on May 31, but both KazMunaiGas and Rosneft remained silent about the mishap. The lack of hydrocarbons in the first well, however, are not expected to deter further exploration. "Energy Ministry does not have information on "dry" exploration well at Kurmangazy," *Gazeta.kz*, June 1, 2006.

<sup>29</sup> "Total not yet interested in developing Kurmangazy," *Time of Central Asia*, June 12, 2006.

<sup>30</sup> For the location of these deposits see the map provided in Appendix I.

## *KMG Transportation Assets*

As already mentioned the single largest holding of KMG is KMG Exploration and Production, with nearly a third of the company's total assets. The company has seven other principal units KazTransOil (oil transportation), and KazTransGaz (gas transportation).

JSC KazTransOil is the largest oil transportation company in Kazakhstan and transports about 65 percent of the oil produced in Kazakhstan. It is 100 percent owned by KMG.<sup>31</sup> KazTransOil controls a domestic pipeline network, over 5800 kilometers of oil trunk pipelines and over 2100 kilometers of conduits. In addition that company has forty pump stations, an oil storage capacity of 1.3 million cubic meters. This network was largely inherited from the Soviet Union. In addition it controls seven percent of the country's water pipelines and 13 percent of Kazakhstan's oil-loading railroad track. It also manages the port of Aktau, from which 7.7 million barrels of oil were loaded in 2005.<sup>32</sup>

KazTransOil's main pipeline goes from Uzen to Atyrau and then on to Samara in Russia (UAS pipeline), which is some 930 miles long and connects the major oil fields of KMG Exploration and Production to the Transneft export pipeline in Russia. KazTransOil also has several smaller pipelines including the Kalamkas-Karazhanbas-Aktau pipeline, a pipeline going from Zhanzhol to Kenkiyak to Orsk (in Russia) and the continuation of the pipeline which starts in Chardjou Turkmenistan, enters Kazakhstan near Chimkent and then goes on to Pavodar and the Omsk in Russia.

KazTransGaz JSC is also 100 percent owned by KMG. It has rights to first refusal for the transport of all natural gas produced in the country. It controls underground gas

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<sup>31</sup> KazTransOil, "General Information," *KTO Website*, <http://www.kaztransoil.kz/index.html?id=267>.

<sup>32</sup> KazTransOil, "Companies Assets," *KTO Website*, <http://www.kaztransoil.kz/index.html?id=272>.

storage, domestic gas transportation and transport of natural gas for export, serving as Kazakhstan's agent in international gas transport. KazTransGaz also is responsible for the sale of gas on the domestic market, the production and processing of natural gas within the country, and has a role in the country's electricity market. It owns more than ten thousand kilometers of gas pipelines and employs about four thousand people.

KazTransGaz is also a partner in KazRosGaz JSC, holding an equal share with Gazprom. This company, established in 2002, supervises the import-export operations of natural gas between Kazakhstan and Russia, and is responsible for supplying gas from the Karachaganak field for processing at Orenburg. It currently only employs about forty people.<sup>33</sup>

KazTransGaz is also the sole owner of JSC InterGasCentral Asia, Intergas Central Asia (ICA) makes a substantial part of its income from the transit of gas from Turkmenistan to Russia. These revenues are negotiated on an annual basis with its shippers, principally with Gazprom, which controls the gas from the time of purchase at the Turkmen border. The tariff for 2007 was set at \$1.10 per 1000 cubic meters.<sup>34</sup> By contrast Uzbek gas transiting into Kazakhstan (largely for sale in Kazakhstan) is under Gazprom's direct control from the time it crosses the Uzbek border<sup>35</sup>, and then Gazprom swaps Kazakhstan for the same volume of gas (in 2007 3.5 billion cubic meters) to be delivered to Orenburg from Karachaganak.<sup>36</sup> As a result of their increased income, ICA has recently spent some \$26 million in pipeline overhauls.<sup>37</sup>

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<sup>33</sup> Kazenergy, *Presentation*.

<sup>34</sup> "Gazprom reached agreement with Kazakhstan on gas transit," *Oil Review*, January 9, 2007.

<sup>35</sup> "Moody's upgrades Intergas Central Asia rating," *IRBIS - News of Kazakhstan Financial Markets*, October 13, 2004.

<sup>36</sup> "Kazakh-Russian-Uzbek gas deal takes effect 1 January," *Times of Central Asia*, January 2, 2007.

<sup>37</sup> "ICA invested KZT 3.3 billion in overhauls," *Oil Review*, August 2, 2006.

NC KMG also controls a 19 percent stake in the Caspian Pipeline Consortium Pipeline (CPC).<sup>38</sup> It also owns a fifty percent interest in Kazakhstan Pipeline Ventures LLC, with British Petroleum, which is has a 1.75 percent stake in CPC.

NC KMG also holds a shared interest in the Kazakhstan-China pipeline project with CNPC. The first stage of the project, approximately 279 miles of pipe stretching from Keniyak to Atyrau, was completed in 2003. The next section, 613 miles of pipe from Atasu to Alashankou, was completed in December 2005, opening direct shipment to China. The final section will connect Keniyak and Kumkol.

NC KMG will be Kazakhstan's representative in the Baku-Tbilisi-Ceyhan pipeline project, although it is unclear what stake they will eventually acquire, and how much will be cash rather than equity. In November 2006 NC KMG announced that it would invest \$1.6 billion to build a link to the BTC pipeline, by 2010.<sup>39</sup> This would cover the coast of construction of a pipeline between Iskene (in Atyrau region) and the port in Kuryk, the purchase of tankers to transport oil from Kuryk to Baku, and the construction of a terminal to unload the tankers in Azerbaijan. The first Kazakh oil could be shipped from Tengiz to BTC as early as 2008, and is expected to grow from 145,000 bbl/d to around 400,000 bbl/d. BTC will be a primary export route for Kashagan oil, and a Memorandum of Understanding between NC KMG and the companies making up the Kashagan consortium group.<sup>40</sup>

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<sup>38</sup> Energy Information Administration (EIA), "Kazakhstan's Oil and Gas Project," Energy Information Administration Website, <http://www.eia.doe.gov/emeu/cabs/Kazakhstan/kazaproj.html>. NS add other shareholders and brief description of the project from outline.

<sup>39</sup> Prime-Tass, November 28, 2006.

<sup>40</sup> "Western Oil Majors Sign MOU on Trans-Caspian Oil Transport," *Kazakhstan Oil and Gas Industry Group*, January 23, 2007, <http://www.kogiguk.com/News/Archive/2007/Jan/Article3070.htm>.

In addition NC KMG controls “Auction Society (AO), National Sea Transport Company (AO NMSK Kazmortansflot), created in 1998, when the Ministry of Transport and Communication was given fifty percent of the stock, and the company itself holding the other half is held by the Ministry of Transportation and Communication. The company is considered a natural monopoly, with taxable income.<sup>41</sup>

Kazmorstransflot consists of two daughter companies, TOO TenizServis and Kazmorstransflot Ltd. TOO Teniz Servis is in charge of on-shore (port) infrastructure necessary for oil production and export, and its shares are divided equally between KMG and AP NMSK Kazmorstransflot. They control docks 4, 5 and 9 in Atyrau, which were transferred to them in return for their financing rehabilitation of ports 4 and 5.<sup>42</sup> Aktau-morport (Aktau Sea Port authority) controls the rest of the ports, and also sets the tariff structure for the port, leading it to sometimes clash with Kaztransmorflot, both on tariffs, and on Kaztransmorsflot’s practices for off-loading freight.<sup>43</sup>

Kaztransmorsflot is also engaged as the commissioner of a major ship-building effort, necessary to support the growing use of tankers to freight oil across the Caspian, a business which will substantially increase once Kazakh oil from Kashagan begins going to Baku. They have contracted with Tengizchevroil to bring on a new class of ship (12,000 metric ton “Astana” class ships) in 2007, and are working with Enka Insaat ve Sanayi A. S. (in partnership with Agip KCO) to bring on even larger ships.<sup>44</sup> Prior to the opening of BTC, in 2005, Kazmorstransflot shipped some 4,714,000 metric tons of oil

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<sup>41</sup> This status is pursuant to Law No. 186 of the 22 August 2003. For more information see “Private fight-Kaztransflot,” *Press Club - Oil and Gas*, September 8, 2006.

<sup>42</sup>Yuliya Mitrofanskaya, “New Draft Amendments to Subsoil and Petroleum Laws,” Speech to the 2005 Kazakhstan International Oil and Gas Conference, October 6, 2005.

<sup>43</sup> “KazTransFlot Stupidly Breaks the Laws of Kazakhstan,” *Press Club – Oil and Gas*, November 24, 2006.

<sup>44</sup> “KazTransFlot, “Highlight of the Year, and Plan for the Future,” *Ogin Mangistau*, February 11, 2006.

across the Caspian.<sup>45</sup> And they are currently charged with responsibility for the expansion of the port at Kuryk. The company would also like to expand into an international freight company trading between China and Europe. The company currently has two-way “dry” freight traffic, moving metals, grain and asbestos, among other cargos between Kazakhstan, Russia and Azerbaijan.

NC KMG also controls Atyrau International Airport, which has plans for major expansion of internal flights as well as direct connections to Russia, China, Uzbekistan and Azerbaijan<sup>46</sup>, and Eurasia-Air Helicopter Company.<sup>47</sup> Although there are periodic rumors that the company wishes to rid itself of the last two firms.

### *NC KMG's Refineries*

KMG own's the Atyrau refinery (oil refinery), and a major interest in the Shymkent refinery, acquired through the sale of PetroKazakhstan to CNPC.<sup>48</sup> These two refineries, as well as a third refinery in Pavlodar supply most of Kazakhstan's domestic fuel.

The Atyrau refinery, in operation since 1945 is currently held by KMG Trading House, which acquired it from KMG Exploitation and Production as part of the latter enterprises effort to divest itself of non-essential assets in advance of its public offering. KMG Exploitation and Production acquired the Atyrau refinery, which processes part of the production KMG Exploration and Production, when it consolidated the Soviet era holdings in western Kazakhstan. The throughput at the refinery from January to June

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<sup>45</sup> “KazTransFlot is building on to their Caspian Fleet,” *Oil and Gas of Kazakhstan*, May 10, 2006.

<sup>46</sup> “Financial reporting about the Trustworthiness of Atyrau Airport,” *Press Club – Investments*, May 22, 2006.

<sup>47</sup> KazMunaiGas, “Structure of Assets,” *KazMunaiGas Website*, <http://www.kmg.kz/index.cfm?tid=22>.

<sup>48</sup> KMG's acquisition of Shymkent came in a two part deal with CNPC. During the first part, CNPC was allowed to buy Canada based PetroKazakhstan, on the condition that it give KMG the option to buy 33% percent of PetroKazakhstan—a stake large enough to give them control over Shymkent Refinery. In the second phase of the deal, KMG agreed to buy 50% of Valsera Holding, PetroKazakhstan's parent company, from CNPC. For more see “Kazakhstan buys part of China oil producer,” *China Economic Net*, July 6, 2006, [http://en.ce.cn/Industries/Energy&Mining/200607/06/t20060706\\_7634319.shtml](http://en.ce.cn/Industries/Energy&Mining/200607/06/t20060706_7634319.shtml).

2005 amounted to nearly 1.8 million metric tons, up 37.4 percent year on year. This reflected \$340 million spent in the reconstruction of the refinery, with plans for further modernization to get the oil processing rate up to between 85 and 92 percent. The modernization of this facility was done by the Marubeni Corporation of Japan, with support of a \$500,000 feasibility study funded by the Japan Bank of International Cooperation.

NC KMG also controls 45.2 percent of the Pavlodar refinery, built in 1978.<sup>49</sup> The government hopes to increase its stake in this company, which in the Soviet era refined Siberian oil, and is the largest refinery in the country. The remainder of the refinery is held by Mangistaumunaigaz. NC KMG seems almost certain to gain a controlling interest of this refinery once Mangistaumunaigaz is sold, it is currently owned by Central Asian Petroleum Ltd., an Indonesian controlled firm, which is rumored to be interested in selling it for \$4 billion.<sup>50</sup>

Pavlodar has faced substantial shortages of oil for processing in recent years, a point of some displeasure on the part of Kazakhstan's Ministry of Industry and Energy, which claims that a number of Russian providers such as Rosneft, Surgutneftegas, were not given spots in the oil supply schedule, and Lukoil received a much reduced slot, and supplies like Tatneft and some small companies working in Timan-Pechora region were unable to get supply to cargo in time to meet scheduled deliveries. The large Russian companies sought refining capacity in Kazakhstan as a way to meeting deliveries to China.<sup>51</sup>

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<sup>49</sup> IntelliNews - *Kazakhstan Today*, November 8, 2005.

<sup>50</sup> "Mangistaumunaigas to be Sold for \$4 Billion," *Oil Review*, December 13, 2006.

<sup>51</sup> "Pavlodar Petrochemical Plant Hopes for a Reliable Russian Oil Shipment," *Interfax*, December 13, 2006.

NC KMG acquired a 52.5 percent stake in the Shymkent refinery, built in 1983, as part of the 33 percent share that CNPC sold KMG in the immediate aftermath of their purchase of PetroKazakhstan<sup>52</sup>, which had owned the refinery, and succeeded in transforming it into the most modern facility in the country, producing some 6 million tons of oil products per year.

#### Other NC KMG Assets

KMG also controls JSC KazMunaiGas Trade House, which helps set Kazakhstan's export policies, and is responsible for the sale of NC KMG's oil and gas products, including establishing business relations with other oil producing countries. In addition it controls the chain of KMG petrol stations. KMG Trade House also has a licensed subsidiary in Switzerland.

The company also controls KazMunaiGas-Service LLP, which provides administrative and logistics support for JSC NC KMG and its various daughter companies. It also controls Munaishy Finance B.V., which is the KMG E and P's financial subsidiary.

## **ORGANIZATIONAL STRUCTURE OF THE COMPANY**

The supervision of KMG is exercised by a five person board of directors, which is headed by Timur Kulibayev, President Nazarbayev's son-in-law, who holds this post simultaneously with that of Vice-Chairman of the "Samruk" holding company. Kulibayev, 40, is married to Nazarbayev's middle daughter Dinara, and is the son of a former senior communist party official. He chaired KazTransOil before the creation of NC KMG. His presence likely serves as a way to protect the interest of the Kazakh president and his family. More than anything else it helps insure that Kulibayev is able to preserve and ex-

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<sup>52</sup> "PKOP Waits for the Modernization Concept," *Oil and Gas of Kazakhstan*, June 29, 2006.

pand his own political position, increasing his likelihood of being the next president of Kazakhstan.

It also includes a vice-minister of energy and natural resources, and of course, Uzakbai Karabalin, the president of KMG. Guglielmo Moscata, the president of Gas Mediterraneo and Petrolio Sri, a former general director of Agip S.p.A. is the one foreigner, and is listed as on “independent” director.

The management of NC KMG is made up exclusively of citizens of Kazakhstan, and in fact most are even ethnic Kazakhs. The members of NC KMG management, though, have quite diverse backgrounds, and were obviously chosen to bring a wide variety of skill sets into the company.

The president of KMG is Uzakbai Karabalin, who has been employed in one form or another in the Soviet and then Kazakh oil industry since 1973, holding leading posts in KazakhOil, KazTransOil, and also serving as Deputy Minister of Energy and Mineral resources before being appointed head of KMG in 2003. Karabalin also spent two years working with AGIP in Italy, his one major form of direct exposure to western management techniques.

The company’s number two, KMG first vice-president Zhaksybek Kulekeyev has a background in mathematics. A statistician Kulekeyev was serving on the faculty at the Almaty Institute of the National Economy at the time of independence. He did not enter state service until late 1995, when he was appointed first vice-president of the country’s State Committee on Statistics and Analysis, then chairing the state statistical agency and finally, in late 1999 he was named Minister of Economics, served as Minister of Education and Science and then Rector of the Academy of State Management. He only joined

KMG in early 2006, after the president's son-in-law Timur Kulibayev resigned the post of first vice-president.

KMG's other vice president, Makhambeet Batyrbayev is also a career oilman who worked at both Emba and at Tengiz and who is a laureate of the USSR's prestigious Gubkin Prize, bearing the name of the prestigious oil and gas institute in Moscow. Kairgeldy Kabyldin, is managing director of KMG's Transport and Infrastructure Projects. He was Vice-President of KazTransOil (and its predecessor organization) from 1997-2002, when Timur Kulibayev was its president. From 1978 until 1997 Kabyldin worked on oil transmission issues, in his native Pavlodar region and then in the Ministry of Energy and Fuel Resources of the republic of Kazakhstan.

KMG's senior management also features someone with several years of experience in Kazakhstan's security system. Daniyar Abulgazin, who is Managing Director for Economics and Finance, is a 1991 graduate of the Felix Derzhinsky Higher School of the KGB of the U.S.S.R., its last class before the dissolution of the country. He was reassigned to work in various branches of the republic's financial structure in the late 1990s, rising to be Vice-Minister of Finance. He joined Kazakh Oil in 2002, and has been with the company ever since.

KMG's E&P's Board of Directors includes three westerners among its eight members; these are all designated independent non-executive directors. The company is run by Aska Balzhanov, who was named General Director of the company in June 2006. Like most of his colleagues Balzhanov is a career oil and gas person, having served as head of KMG's off-shore oil and gas operations before coming to KMG E&P.<sup>53</sup>

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<sup>53</sup> KMG E&P Management:

## RELATIONSHIP OF NC KMG TO THE GOVERNMENT

### *Through the President and the Cabinet*

NC KMG has both a direct and indirect relationship to the government, and to the president of Kazakhstan, Nursultan Nazarbayev. His son-in-law Timur Kulibayev remains a prominent member of Kazakhstan's national oil industry, a relationship which is returned to in the conclusion. More importantly, the president of Kazakhstan himself still is at the center of the country's oil and gas policy. He appoints the Prime Minister, a choice ratified by parliament, and although the Prime Minister formally appoints the rest of the government, he does so with clear support from the president. Similarly, the president is also consulted in key appointments in the country's oil and gas sector, although many of these are made formally by the Ministry of Energy and Natural Resources. NC KMG is also subject to regulation by the Committee for Financial Control and State Procurement of the Ministry of Finance, the Ministry of Environment Protection, and the Ministry of Labor and Social Protection. Moreover, President Nazarbayev seems to take advice from a small group of people who have held key positions in the oil and gas sector in the last decade, in ministries, in KMG, and in the office of the president.

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- Askar K. Balzhanov, General Director, previously managed JSC "KazMunaiTeniz", a subsidiary of NC KMG specialising in off-shore oil and gas operations.
  - Vladimir Miroshnikov, First Deputy of General Director, has been working in oil and gas industry since 1973 with Uzenneft NSEH.
  - Zhanneta Bekezhanova, Deputy General Director on economics and finance, previously held positions with the Kazakh Trade House in Hong Kong and with KazTransOil.
  - Kairolla Erezhepov, Head of the Company's Staff, spent nine years as a Deputy of Kazakhstan's Parliament and has been awarded the Parasat order and Astana medal.
  - Murat Kurbanbayev, Director of UMG, has over 30 years professional experience in the oil and gas sector.
  - Maksim Izbasov, Director of EMG, previously served as first Vice President with PC Tengineftegaz and, since 1999 as head of OGPU Kulsaryneft. He holds the Kurmet Order Award.
  - Askar Aubakirov, Deputy General Director of Corporate Development, has worked in the oil and gas industry since 1999.

\*KazMunaiGas Exploration and Production, "Management," KazMunaiGas E&P Website, [http://eng.kmgp.kz/the\\_company/corporate\\_governance/management](http://eng.kmgp.kz/the_company/corporate_governance/management).

The government of Kazakhstan holds the major reins of power in the country's oil and gas industry. Although there has been a much greater effort in recent years to introduce greater transparency into the decision-making structures that affect this sector, there is obviously a long way to go before the industry is fully transparent. However, the recent IPO for KazMunaiGaz Exploration and Production provides a great deal more information about the operation of the industry than was previously available

### *Through Legislation*

KMG, as all other oil companies are governed by a series of laws passed by the government of Kazakhstan. All subsurface use contracts are drawn up in accordance with four major pieces of legislation: the Subsurface Use Law<sup>54</sup>, The Petroleum Law<sup>55</sup>, the Tax Code<sup>56</sup> and the PSA Law.<sup>57</sup>

The 2004 PSA Law, which replaced earlier legislation from 1995, required for the first time that all new production sharing agreements include at least a fifty percent stake to be held by KMG, and their participation would effectively be funded by the other partners. In addition, PSA's were now restricted solely to off-shore deposits, and the companies developing these deposits were required to have greatly expanded "local content" to the projects, both in terms of services and products.

Many of these provisions were then extended to all projects, in October 2005 with the promulgation of a set of modifications on legislation governing the utilization of natural resources and oil operations. One set of critical changes occurred in October 2005

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<sup>54</sup> Law No. 2828 of the Republic of Kazakhstan, "Concerning the Subsurface and Subsurface Use," January 27, 1996.

<sup>55</sup> Law No. 2350 of the Republic of Kazakhstan, "Concerning Petroleum," June 1995.

<sup>56</sup> Code of the Republic of Kazakhstan, "Concerning Taxes and Other Obligatory Payments to the Budget," June 12, 2001. Available online at <http://www.kazakhstanembassy.org.uk/cgi-bin/index/209>.

<sup>57</sup> Law of the Republic of Kazakhstan, No. 68-III on Production Sharing Agreements for Offshore Oil Operations dated July 8, 2005.

with the promulgation of a set of modifications on legislation governing the utilization of natural resources and oil operations. Most critically this substantially increased the role of the government in the transfer of shares of existing projects<sup>58</sup> by elaborating a greater right of the government to protect the country from contracts which threaten the “economic interests” of Kazakhstan. This has led to a greatly enhanced position for KazMunaiGaz. It also allows the state to refuse to allow transfers of ownership on grounds of national security.<sup>59</sup>

KMG and its various daughter companies are also subject to the country’s Corporate Governance Code.<sup>60</sup> The laws that constitute the governing scheme for the oil and gas sector in Kazakhstan have been subject to many important amendments—one of the most significant coming in 2005. At that time, restrictions were placed on the flaring of gas. Up to that point, the managers of Kazakhstan’s major hydrocarbon consortia had flared up to of the gas produced for their deposits.

The changes to the hydrocarbon regime and indeed many of KMG’s tactical moves clearly follow the plans laid out for the oil and gas industry in two other important pieces of legislation: The Government of Kazakhstan’s Plan for its Sector of the Caspian Sea, passed in May of 2003,<sup>61</sup> and The Government of Kazakhstan’s Development Plan for the Petrochemical complex of Kazakhstan.<sup>62</sup>

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<sup>58</sup> See especially articles 15 and 19 of the 2005 amendments to the Petroleum Law of 1995. Law No. 79 of the Republic of Kazakhstan, “Concerning the Amendment of Certain Legal Acts of the Republic of Kazakhstan on the subjects of Petroleum,” October 14, 2005.

<sup>59</sup> Mitrofanskaya, *Draft Law Amendments*.

<sup>60</sup> Association of Financiers of Kazakhstan, *Corporate Governance Code of Kazakhstan* (Almaty: Association of Financiers of Kazakhstan). Available online at <http://www.corpgov.kz/codex/>.

<sup>61</sup> Edict No. 1095 of the President of the Republic of Kazakhstan, “On the Government Development Program for its Sector of the Caspian Sea” of May 16, 2003. Available online at <http://www.transeurasia.kz>.

<sup>62</sup> Order No. 101 of the Government of the Republic of Kazakhstan, “On the Government’s Program for the Development of the Petrochemical industry of Kazakhstan between 2004-2010,” of January, 29 2004. Available online at <http://www.transeurasia.kz>.

The first of these documents, on the development of Kazakhstan's sector of the Caspian Sea, is by far the more important of the two. The underlying purpose of the plan is to make the Kazakh "sector as attractive and mutually beneficial to investors as possible"—at least according to official line. But it is clear that the document also aims at protecting Kazakhstan's interest in the Caspian, outlining its expectations for how its natural resources are to be used. The plan outlines three main tasks in the development of the Caspian: 1) increasing the production to the stable high level and developing infrastructure; 2) the creation of domestic industries and formation of own scientific-technological basis; 3) the advancement of human development and advanced technical training.<sup>63</sup> The document also sets some notable goals for consortia member operating in the Caspian, most notably listing the coming online of gas production at Kashagan as one of its key steps in implementing its plan.

In addition, this legislation outlines Kazakhstan's strategy toward Russia and other foreign actors, detailing Kazakhstan's agreements with both Russian and Azerbaijan as to the delineation of the Caspian, but also dealing with transportation issues. The need for the development of a multitude of exports routes is mentioned in the plan.

The plan list three stages of implementation: the first from 2003-2005, was to focus on the development of infrastructure and the training of Kazakhstani personnel; the second between 2006 and 2010 was intended to be a period of rapid growth of hydrocarbon production (although in fact the Kazakhs are somewhat off schedule); and the third, from 2011 to 2015, is to bring the off-shore production to a stable high level, enhance

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<sup>63</sup> Embassy of Kazakhstan in the UK, "Oil and Caspian Off-Shore Development Strategy," *Embassy of Kazakhstan in the UK's Website*, <http://www.kazakhstanembassy.org.uk/cgi-bin/index/66>.

capacities for hydrocarbon export transportation and oil and gas processing.<sup>64</sup> The plan lists KMG as the government body tasked with the implementation of this plan, which gives them substantial ability to pressure their consortia partners to hire and purchase locally (even beyond the minimum requirements of their contracts).

Taken in concert, this legislation is designed to create an uneven playing field in the country, one which favors the interests of NC KMG and its daughter companies.

### *Samruk*

Pursuant to two presidential decrees in 2006 (from January and May), the government shares of KMG Exploration and Petroleum were transferred to a new holding company “AO Samruk Holding” which was created at the alleged urging of McKenzie, Inc., to sharply reduce the role of ministerial corruption in the running of state-owned corporation. Samruk, does not actually run these companies, but is charged with the responsibility of managing the portfolio of shares, functioning as an asset management company. It votes the government shares, and so effectively establishes the developmental and other policy guidelines for the company.

In October 2006 former BAE chairman Sir Richard Evans, was named chairman of the company.<sup>65</sup> Coincidentally BAE owns 49 percent of Air Astana, Kazakhstan’s largest airline. Former Minister of Trade and Industry Suat Minbayev (generally viewed as a trusted ally of Nazarbayev) served as the first Chairman. Timur Kulibayev holds the post of deputy chairman in the five person board. The Minister of Economics and the Minister of Finance also serve on the Board, as does another independent director. But the structure still gives President Nazarbayev an almost automatic majority.

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<sup>65</sup> “Sir Richard Evans to Chair Samruk Holding,” *Kazakhstan Oil and Gas Industry Group*, November 15, 2006, <http://www.kogiguk.com/News/Archive/2006/Oct/Article2747.htm>.

In addition to KazMunaiGas, 100 percent of the shares of Kazpochta (the postal service), and KEGOC (the Kazakhstan Electricity Grid Operating Company) and Kazakhstan Temir Zholy (the railway) have also been transferred to Samruk, and 50 percent plus one share of Kazakhtelecom has been transferred as well. The transfer of shares to Samruk did not adversely affect the Standard and Poor's ratings of these companies.

Samruk, though, is in the very early stages of its existence, and it is very hard to predict how it will operate over the long-term, whether it will try first and foremost to be send the message that Kazakhstan is an investor friendly place, increasing the attractiveness of Kazakh offerings in foreign capital markets, or alternatively be an aggressive management fund, seeking to assert strong state influence over the direction of development of key state-held assets.

The stated intent of the fund is the former, but there is nothing in its structural makeup that precludes it from behaving in the latter fashion, especially under some future president or alternative constitutional structure.

#### *KazMunaiGas Exploration and Productions Relationship to KMG*

NC KMG's share of KMG E and P will never drop below 60.1 percent, and because of this they will continue to be able to control the majority of votes at general shareholder's meetings, which in turn will guarantee their control over the Board of Directors of the company. This, as noted in the global offering, will insure that NC KMG is able to determine the timing and amount of dividends, to influence the hiring of all the key personnel positions in the company, and to enter into mergers or make acquisitions that are deemed important by the government of Kazakhstan, but which may be opposed by minority shareholders. They also are able to effectively block minority share holders

from holding shareholders meetings that they object to, due to the quorum rules set up for the company.<sup>66</sup>

NC KMG and KMG E and P have a relationship agreement which is intended to mitigate some of the influence NC KMG exercises, as NC KMG pledges to allow KMG E and P to operate independently from the NC KMG groups, and that KMG E and P is to be allowed to operate in the interests of all shareholders equally. The relationship agreement is to apply as long as NC KMG holds at least 30 percent of the shares of the company. To this end certain kinds of material transactions must be approved by the Independent Non-Executive directors. These include any transactions between the KMG E and P and NC KMG, any major acquisitions or disposals, the company's dividend policy, changes in the relationship agreement, the service agreement and the company's charter and corporate governance code.<sup>67</sup>

But, there is no enforcement mechanism to secure the agreement NC KMG and the directors it appoints to abide by the relationship agreement, save that the KMG E and P directors can withhold payment to NC KMG for the annual service contract. But of course, if they were to do so NC KMG would withhold services, leaving KGM E and P without the ability to transport and export its oil.

KMG E and P has a yearly service contract with NC KMG, which expires each December 31 and must be renewed through an annual tender grants the country a significant number of privileges. As long as this relationship exists KMG E and P will effectively be free to transfer a percentage of its profits directly to NC KMG. Although Non-executive (i.e. independent) directors of KMG E and P can try and prevent increases to

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<sup>66</sup> LSE, *KMG EP IPO*, 30.

<sup>67</sup> LSE, *KMG EP IPO*, 31.

the sum paid in this service agreement, they cannot affect the size of the current monetary transfer. KMG E and P paid \$87.6 million in management fees in 2005. In addition they paid commissions for crude oil sales of \$5.7 million and \$ 225.6 million transportation services.<sup>68</sup>

The service agreement provides KMG E and P with the right to request the state to exercise the right of first refusal to acquire shares in any on-shore subsoil oil and gas exploration and production contracts that an existing shareholder wishes to transfer. The service agreement also gives KMG E and P the right to request NCKMG exercise its rights to enter into direct negotiations for exploration and production contracts for any unlicensed oil and gas acreage in Kazakhstan, without engaging in a tender process, and the right to acquire oil and gas exploration contracts for such acreage.<sup>69</sup>

It is theoretically possible that this will not be renewed, especially if NC KMG wants to go in another direction, and form an additional production company. Similarly KMG E and P can lose its production and exploration contracts in the same way that any other company can.

KMG E and P has a contract with KazTransOil to ship its oil through the UAS (Uzen-Atyrau-Samara) pipeline through 2012. The tariff for this is set by the Ministry of Energy and Natural Resources and can be reviewed by the Kazakh Antimonopoly Commission at the request of KTO. The tariff charged can not be less favorable to KMG E and P than that applied to other pipeline users.

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<sup>68</sup> LSE, *KMG EP IPO*, f. 25.

<sup>69</sup> LSE, *KMG EP IPO*, 9.

The service agreement also commits NC KMG to make “reasonable efforts” to procure KMG E and P sufficient capacity from the CPC pipeline.<sup>70</sup> Of course there is no guarantee that NC KMG will remain a CPC stock holder, which means that KMG E and P has some risk that it will not have adequate transport options for its oil and gas. This risk, though, is less than that experienced by other oil producing companies operating in the country, assuming that the Kazakh government doesn’t fundamentally restructure its oil and gas development strategy.

KMG E and P is also required by KMG to sell a certain percent of its oil to the Atyrau refinery each year, at the cost of production and transport plus three percent. This is discussed at greater length below.

There is also risk that the relationship between KMG E and P and KMG can bring to minority shareholders. There is a chance that KMG will decide not to renew the yearly service arrangement with KMG E and P. While this is unlikely in the immediate future, a future Kazakh President (or Prime Minister if the powers of the president were to be constitutionally weakened, could rethink of energy policy, and decide to have several competing firms which would represent national interests. Or they could decide to largely abandon the idea of a national oil firm, and transform KMG E and P into an entirely private or at least wholly commercial project. This is what effectively happened to Lukoil in Russia.

Clearly the biggest risk to KMG E and P is that the Board of Directors nominated by NC KMG will exert an influence which is against the best commercial interests of the company, but which reflects government interests.

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<sup>70</sup> Ibid, 22.

## PERFORMANCE AND BEHAVIOR

### *NC KMG*

KMG articulates its mission and vision on its website,<sup>71</sup> including as its goals the maximization of economic benefits of the company through an increase in the Company's value, through improvement of the financial and economic parameters, through increasing its reserves of hydrocarbon raw material, through increasing efficiency of production, and through advancing the strategic interests of the State, including guaranteeing its energy security.

Many of the goals of the company cannot be fulfilled until some distant future. The company has been a profitable one, largely because it has been able to benefit from favorable trends in the global oil market. Supported by the unexpectedly high price of oil for most of this year, KMG's profits grew by 29.7 percent, year on year, for the first eleven months of 2006, and totaled some \$5.2 billion.<sup>72</sup>

Much of this came from KMG Exploration and Production, which produced 10.5 million tons of oil and gas condensate, up 2.2 percent from the previous year.<sup>73</sup> The company reports that the major part of its net profit (some \$234 million for the first five months of 2006) was channeled into production.<sup>74</sup> Their gross profit for 2005 was \$3.8 million.

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<sup>71</sup> KazMunaiGas, "Mission," *KazMunaiGas Website*, <http://www.kmg.kz/index.cfm?tid=20>.

<sup>72</sup> "KazMunaiGas reports on production of oil and gas condensate" *Alexanders Oil and Gas Connection*, December 8, 2006, <http://www.gasandoil.com/goc/company/cnc64973.htm>.

<sup>73</sup> KazMunaiGas Exploration and Production, "JSC KazMunaiGas Exploration Production has increased oil production in 2006," *KMG E&P Website*, January 18, 2007, [http://eng.kmgep.kz/press\\_center/news/jsc\\_kazmunaigas\\_exploration\\_production\\_has\\_increased\\_oil\\_production\\_in\\_2006](http://eng.kmgep.kz/press_center/news/jsc_kazmunaigas_exploration_production_has_increased_oil_production_in_2006).

<sup>74</sup> "KazMunaiGas revenue made KZT 297.2 bln for 5months," *Kazinform*, June 14, 2006, <http://www.inform.kz/showarticle.php?lang=eng&id=142663>.

Since the beginning of its operation between eighty and ninety percent of the company's profit has been made by KMG Exploration and Production, with the extraction outfit, KazTransOil and KazTransGas accounting for most of the rest.<sup>75</sup>

### *Taxation*

Kazakhstan has a complex system of taxation for subsurface users, which is explained in depth by Ernst and Young in their annual publication "Kazakhstan Oil and Gas Tax Guide."<sup>76</sup>

There are two separate types of subsurface use contracts, Production Sharing Agreements (PSA's) which the tax legislation calls "model 2" tax regimes, and standard contracts which subject the license holders to excess profit taxes. These are considered "model 1" tax regimes. Part I of Appendix VII describes which kinds of taxes each kind of contract is liable for.

KMG participates in both kinds of contracts. Virtually all of the major international consortia development projects are based on PSA contracts, which since the 2004 regulation are only to be granted for off-shore oil projects, whereas the older KMG fields (which are part of KMG Exploration and Production) are based on "model 1" tax regimes. The tax regimes of PSA's signed before the new PSA legislation are stabilized, whereas those signed afterward are stabilized only if they have undergone evaluation by tax authorities to guarantee that they are in compliance with the tax regimes in place at the time that the contract was negotiated. The stabilized contracts can be renegotiated to take advantage of changes in the tax regime only with the approval of the government,

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<sup>75</sup> "KMG announces Profits," *Times of Central Asia*, January 28, 2005.

<sup>76</sup> Ernst and Young, *Kazakhstan Oil and Tax Guide: 2006 Edition* (Kazakhstan: Ernst and Young: 2006). Available online at [http://www.ey.com/global/content.nsf/Kazakhstan\\_E/Home](http://www.ey.com/global/content.nsf/Kazakhstan_E/Home).

and require compensation be paid to the government. “Model 1” contracts are not stabilized.<sup>77</sup>

The Tax code<sup>78</sup> offers very specific information about what must be included in a PSA.<sup>79</sup> It also provides a list of expenses that are recoverable under a PSA,<sup>80</sup> and non-recoverable.<sup>81</sup> The legislation also outlines the triggers to determine the sharing of profit production.<sup>82</sup>

The newer legislation (the Tax Code and new PSA law) also move Kazakhstan away from a bonus system, and so all contracts negotiated after July 1, 1998, have provisions for royalties only.

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<sup>77</sup> *Ernst and Young*, 8-9.

<sup>78</sup> Code of the Republic of Kazakhstan, “Concerning Taxes and Other Obligatory Payments to the Budget” of 12 June 2001.

<sup>79</sup> The Tax Code stipulates that the PSA must include: 1) a determination of the volume and monetary value of production; 2) a determination of the total percentage of production to be used for cost recovery; 3) a determination of the share of production to be shared between the producer and the Kazakh Government after cost recovery; 4) the percentages of profit to be shared between the producer and the Kazakh Government; 5) the procedure for the share of the Kazakh government in profit production in accordance with the tax code. *Ernst and Young*, 15.

<sup>80</sup> Recoverable Expenses under a PSA: 1) expenses borne by Subsurface user prior to the signing of the contract, including expenses on the feasibility study, and exploration; 2) expenses actually borne by the subsurface user from the date when the contract comes into force and during the period of its validity.

<sup>81</sup> Non-Recoverable expenses under a PSA : 1) expenses on the payment of a fee for participation in tenders for subsurface rights; 2) expenses on the purchase of geological information; 3) expenses in excess of the limits establishes by the contract, including those related to administrative expenses; 4) expenses on the payment of the fee for pollution of the environment exceeding established limits; 5) expenses related to the sale of the cost production and part of profit production owned by the subsurface user; 6) expenses related to the audit of the activities performed at the request of owners; 7) expenses incurred as a result of failures in performance by the subsurface user of the responsibilities stipulated in the contract; 8) expenses related to excursions and traveling; 9) expenses on payments of interest on laons and for use of borrowed funds; 10) loses incurred due to accident caused by subsurface user; 11) expenses from social projects; 12) expenses for the voluntary insurance of employees; 13) costs incurred in connection with legal proceedings; 14) fines and interest penalties imposed by any state bodies on a subsurface user; 15) cost relating to the payment of expenses to be used for the personal needs of employees; 16) bonuses; 17) taxes and obligatory payments paid in the budget. *Ernst and Young*, 18-19.

<sup>82</sup> Triggers that determine profit sharing: 1) R-factor (profitability index)—the ratio of subsurface user’s accumulated income to accumulated expenditure under the project; 2) internal rate of return of contractor—discount rate when net real discounted income reaches its zero value; 3) P-factor (price factor)—ration of subsurface user’s income to the total production volume during reporting period. *Ernst and Young, Kazakhstan 2006*, 18-19.

Kazakhstan has a system of graduated royalties, applied to each type of mineral resource, payable in cash, and calculated by multiplying the production by a netted back price and applying the appropriate royalty rate.<sup>83</sup> In 2005 an amendment to the Tax Code added a new type of subsurface activity, which seems intended to access royalties on pipelines and oil and gas storage facilities.<sup>84</sup> Ernst and Young accountants believe that the 2005 amendments still leave the royalty structure for pure gas fields unclear, but infer that the calculation should be similar to that offered for associated gas.<sup>85</sup>

Legal entities selling crude oil and gas condensate for export are subject to an economic rent tax, although PSA holders are exempt from this when making sales from their own contract area. This tax is based on a government determined market price, as determined by a Resolution of the Government of Kazakhstan from August 15, 2005,<sup>86</sup> based on a scale reproduced in Part III of Appendix VII.

As already noted, “model 1” contract holders are subject to an excess profits tax, which is levied on net income in excess of twenty percent, and will start to apply once the ratio of cumulative aggregate income to cumulative tax deductions exceeds 1.2. The tax base can be adjusted for expenditures incurred for the education of the local Kazakh work force and/ or to increase for the increased in fixed assets, but in total this cannot exceed 10 percent of the taxable amount. Taxes are based on a sliding scale, not to exceed 60 percent.<sup>87</sup>

Subsoil users are also subject to corporate income tax, which is set at about 30 percent of the taxable income. The legislation is very specific about the kinds of deduc-

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<sup>83</sup> See Part II of Appendix VII.

<sup>84</sup> Ernst and Young, *Kazakhstan 2006*, 12.

<sup>85</sup> *Ibid*, 13.

<sup>86</sup> *Ernst and Young*, 14.

<sup>87</sup> *Ibid*, 14-15. See parts IV and V of Appendix VII for example of how the tax regime is applied.

tions which can be taken<sup>88</sup>. It also sets guidelines for the depreciation of assets.<sup>89</sup> In addition to corporate taxes, a subsoil user may also be subject to a branch profits tax.<sup>90</sup>

PSA holders are also liable for payment of a “top-up” tax to insure that the State’s take is no less than the statutory minimum. Each PSA sets this based on the project, and it is usually in the range of 5 to 10 percent, and following the life of the PSA it can reach 40 percent.<sup>91</sup>

All projects are subject to a variety of environmental fees, based on the nature of the activities of the project. These fees are almost always paid to the localities in which the project is based. These include fees for land usage,<sup>92</sup> fees for water usage,<sup>93</sup> fees for the use of specially protected natural reserves,<sup>94</sup> and fees for the pollution of the environment.<sup>95</sup> Less commonly applied fees include those for use of a radio frequency and for use of navigable waterways.

Subsoil users must also pay a value-added tax on crude oil, natural gas and gas condensate sold in Kazakhstan, which in 2006 was 15 percent, but export sales do not

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<sup>88</sup> Examples of acceptable deductions: 1) Interest expense (within limits); 2) Contributions to Decommissioning Fund; 3) expenditures on geological studies and exploration and preparatory operations for extraction of mineral resources; 4) expenditures on Research and Development and scientific and technological works. *Ernst and Young*, 28.

<sup>89</sup> The Maximum depreciation rate for buildings and structure, excluding oil and gas wells and transmission devices in 10 percent; for machinery and equipment, except machinery and equipment of oil and gas production, 25 percent; for office machinery and computer, 40 percent; and for fixed assets not included in other groups, 15 percent. *Ernst and Young*, 29.

<sup>90</sup> In addition to corporate income tax, foreign legal entities are responsible for a branch profit tax of 15%, levied on net income after corporate tax. *Ernst and Young*, 29.

<sup>91</sup> *Ernst and Young, Kazakhstan 2006*, 21.

<sup>92</sup> The fee for the use of a plot of land is collected by the state for leased plots of land. The rates of the fee are determined in accordance with the land legislation of Kazakhstan and cannot be lower than those of land tax. *Ernst and Young, Kazakhstan 2006*, 22.

<sup>93</sup> Water use of all types is taxed in Kazakhstan according to special legislation. The amount of the fee is determined based upon the type of water use. *Ernst and Young, Kazakhstan 2006*, 22.

<sup>94</sup> Fees for the use of nature reserves are collect by the government and used to preservation and cultural programs. The fee is based on an act of the Kazakh government and is assessed for each individual case. *Ernst and Young, Kazakhstan 2006*, 23.

<sup>95</sup> Pollution fees are assessed on the amount of emission and are governed by the government’s acts on the preservation of natural resources. *Ernst and Young, Kazakhstan 2006*, 23-24.

have a VAT levied. Geological prospecting is exempt from VAT levies. Imported goods may be subject to customs duties of up to 30 percent, with exemptions provided for contracts negotiated before the new customs code (2003) was introduced.<sup>96</sup> All goods may be subject to paying customs clearance fees.

Crude oil and gas condensate is subject to excise tax from the time of sale or transfer to a refinery. In 2006 this rate was set at zero.<sup>97</sup> Subsoil users are also liable for property tax, land tax and vehicle tax.<sup>98</sup>

### *KMG Exploration and Production*

KMG's management believes that the value of the assets of KMG is seriously undervalued, and one way of rectifying this is to float shares in part of the company, the Exploration and Production unit, internationally.<sup>99</sup> This offering, designed to raise \$1.9 billion, was offered on the London Stock Exchange in October 2006, the capital to be used to purchase the shares acquired by KMG in PetroKazakhstan and KazGermunaigaz, both of which are in Kazakhstan's Turgai Basin. Prior to this offering over 97 percent of the shares of KMG E and P were held by NC KMG; the remaining shares having been bought by workers and management during the early stages of Kazakhstan's national privatization process.

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<sup>96</sup> The Customs Code of the Republic of Kazakhstan of 5 April 2003 effective from 1 May 2003. Available online at <http://www.kazakhstanembassy.org.uk/cgi-bin/index/209>.

<sup>97</sup> Excise tax for petrol was \$4.2-42.2 per ton for domestically produced and \$.18 per ton for petrol imported from Europe. Only domestic diesel fuel qualified for an excise tax of \$0.5-5 per ton, and crude oil, including gas condensate had 0 excise tax. Ernst and Young, *Kazakhstan 2006*, 33.

<sup>98</sup> Property tax is 1 percent of the average residual book value of depreciable assets per annum other than vehicles and land. Land tax varies from \$0.004 to \$49 per hectare depending on quality and purpose. Vehicle Tax is paid annually and computed based on monthly computation indices. Ernst and Young, *Kazakhstan 2006*, 34.

<sup>99</sup> "KMG 's IPO," *Oil and Gas of Kazakhstan*, June 29, 2006.

KMG E and P shares are also being sold on the Kazakhstan Stock Exchange, but they are subject to a \$50,000 threshold, effectively making purchase of shares impossible for ordinary Kazakh citizens.<sup>100</sup>

In August 2006, KMG E and P approved a dividend payment of \$2.90 per share, this compares to a dividend of \$.55 per share in 2005, \$.44 per share in 2004, and \$.30 per share in 2003. KMG E and P are currently restricted to a total dividend payment of \$3.9 million per year by the terms of the \$800 million loan that Munaishy Finance, took with Esomet, of France. This 6.5 percent fixed rate loan is payable by September 2009, and is discharged through the sale of KMG E and P oil by Esomet.<sup>101</sup>

It is interesting to note that in KMG E and P's IPO they note the accounting systems of the company as an area of financial risk for potential investors. KMG E and P uses the International Financial Reporting Standards (IFRS) accounting system,<sup>102</sup> but its personnel have limited experience with using it, and don't understand how to properly use its applications. As a result, the IPO notes, the company's internal controls are weak, and management is not confident that mistakes in the preparation of its financial statements will be readily detected by those charged with preparing them.<sup>103</sup> KMG E and P hopes to address this in part through the adoption of new software, the Enterprise Resource Planning software, which is scheduled to be introduced by the end of 2007.<sup>104</sup>

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<sup>100</sup> "The Country Needs to Articulate a Solid Political Strategy for the Gas Market," *Ekspert Kazakhstan*, October 25, 2006, <http://www.expert.ru/printissues/kazakhstan/2005/22/>.

<sup>101</sup> LSE, *KMG EP IPO*, 37.

<sup>102</sup> IFRS's are a set of rules that tell companies what should be included in a financial statement and how to calculate those item. They are set by a panel of 14 experts, who form the International Accounting Standards Board, based in London. For more information see the IASB homepage <http://www.iasb.org/Home.htm>.

<sup>103</sup> LSE, *KMG EP IPO*, 27.

<sup>104</sup> *Ibid*, 28.

KMG E and P is subject to local and national tax regimes of the “model 1” type, described above. Its management, too, like foreign oil and gas companies operating in the country, have complained of the difficulties of understanding some of this legislation, which they maintain is the reason why they have been subject to a number of claims by the tax committee of the Kazakhstan Ministry of Finance, with regard to alleged underpayment of cash royalties and taxes. Penalties are quite high, up to 50 percent of the underpayment.<sup>105</sup>

One area that KMG E and P’s practices have caused raised eyebrows relates to their alleged illegal transfer pricing practices. Rumors of transfer pricing have surrounded many of the daughter companies of KMG, and cases of investigation by tax authorities have been infrequent. The price oil sold to KMG Trade House AG, a Swiss subsidiary of KMG Trade House, is supposed to be set based on the mean quotations published in Platts Crude Oil Marketwire less a discount to cover the Swiss trading house’s transportation, insurance, financing and other expenses, plus a trader’s commission.

In November 2004, the tax committee, along with the Department of National Security (Department of Customs and Control and the Department of Economic Crimes) launched a joint audit of both UMG and EMG to verify the amount of the discount on export price sold to KMG Trade House AG, for the period 2001 through 2003 for UMG and 2003 for EMG, and in February 2005 the tax committee assessed KMG E and P \$17.9 million for underpaid taxes and royalties, due because the discounts were said to have exceeded allowable amounts, and so were in violation of the country’s applicable transfer pricing laws and regulations. But this decision was overthrown by the Kazakh

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<sup>105</sup> Ibid, 29.

Supreme Court in February 2006.<sup>106</sup> But NC KMG and its daughter companies seem to be treated much like any other company; sometimes the courts find for them and other times they find against them,<sup>107</sup> and it is highly unlikely that the KMG companies resort to bribing judges or local officials.

It is very possible that transfer pricing will become an area of growing future concern for the company, especially if the political environment in the country loosens up at all, and “independent minded” prosecutors seek to make a reputation for themselves.

The management of KMG E and P is already deeply concerned about the ambiguities in the tax legislation which they believe leave them vulnerable to tax claims. One of the ambiguities concerns what rate should be applied to the transfer of oil to Atyrau refinery, whether it is considered an out of contract activity and so liable for VAT charges. With regard to this specific ambiguity KMG E and P has set aside a \$17.9 million fund to cover their possible exposure from 2002-2005, but even they admit that they could easily be liable for another \$59 million KZT for excess profits tax on the Uzen deposit, because they deducted EPT in the previous year and tax on dividends when figuring out how much EPT to pay. Finally, they admit to vulnerabilities with regard to the payment of social taxes on salaries in the service division, whether current or stabilized

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<sup>106</sup> Ibid, 29.

<sup>107</sup> Kazakh judicial decisions are largely available on the websites of the various courts. In a sampling of court cases, the results for KMG were very much mixed. For example, out of a sampling of four judgments that I contend are typical, three out of four were decided partially or wholly against KMG. Two are judgments by the tax courts, one for KMG, one against them; the third case was brought by a critic of the tender process, and the fourth by someone employed by the firm. In the latter two judgments went partly or entirely against the defendant (i.e. a daughter company of KMG). See Decision No. 3a-74-06; Decision No. 3a-58-06; Case No. 2-627/3-04; and Decision No. 2a-157/2005 all available online at <http://www.supcourt.kz/>.

tax rates should apply. The management here believes that their tax liability could be an additional \$5.6 million for 2001-2005.<sup>108</sup>

Again, these are potential liabilities that KMG E and P accountants have identified, and doesn't mean that Ministry of Finance accountants wouldn't offer many more. Most importantly, though, this speaks to the lack of a fully comprehensible tax structure and the unpredictability of its application.

## **NON-COMMERCIAL ACTIVITIES**

### *Subsidized Oil and Gas*

KMG E and P is required to provide oil to the Atyrau Refinery, for sale on the Kazakh domestic market. This obviously has a clear effect on the profitability of this now publicly traded firm, for while 28 percent of the oil produced by KMG E and P is sold on the domestic market,<sup>109</sup> these sales account for only 12 percent of the company's profit.<sup>110</sup>

In 2005 KMG E and P executed a Refinery Supply Undertaking with KMG Trade House to supply the Atyrau Refinery with not more than 1.9 million metric tons of crude oil per year for the period 2006 through 2010, at a price equal to the company's cost of production and transportation, plus a margin of 3 percent. For the period 2011 through 2015 the volume of crude oil to be supplied will be determined by KMG E and P's business plan, as approved by the Board of Directors, but this is expected to be the same amount and sold under the same conditions.<sup>111</sup>

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<sup>108</sup> LSE, *KME EP IPO*, 29-30.

<sup>109</sup> LSE, *KMG EP IPO*, 71.

<sup>110</sup> LSE, *KMG EP IPO*, 13.

<sup>111</sup> LSE, *KMG EP IPO*, 21.

In addition, the government can, and has, demanded additional oil be provided to the Atyrau refinery, as part of the Refinery Supply Undertaking, and bar the export of oil until the requested additional delivery is provided. In 2006, KMG E and P anticipated that their addition supply requirements would be an additional half million metric tons (bringing their total supplied to 2.4 million metric tons). The price for the additional supply is negotiated separately, and may be set as low as the cost of production.<sup>112</sup>

KazTransGaz is required to provide subsidized gas for the population of the Taraz region in southern Kazakhstan, a region located near the borders of Kyrgyzstan and Uzbekistan that had traditionally been served by gas from Uzbekistan. But in 2004, after the Uzbek government sharply raised their tariffs for foreign customers (tariffs which had been steadily rising since independence). This gas was provided through the development of the Amangeldy gas deposit, located some 10 kilometers from Taraz, which provided gas for the entire oblast of Jambyl, at a price of \$22 for 1000 cubic meters rather than \$72, which was the new price demanded by the Uzbeks.<sup>113</sup>

Amengeldy was a relatively small deposit, some 25 billion (milliard) cubic meters, in an area of the country that requires some 1.5 billion cubic meters per year.<sup>114</sup> In the mid-1990s there were plans to develop the Amengeldy field, as a part of a group of fields (that were grouped together as AOS Dobol), but these plans collapsed when Unocal made the decision to pull out of Central Asia following the failure of their proposed gas pipeline to Afghanistan.

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<sup>112</sup> Ibid, 22.

<sup>113</sup> KazTransOil, "A full disclosure of tariffs for certain regions in 2006," *KTO Website*, [http://www.kaztransgas.kz/article.php?article\\_id=88](http://www.kaztransgas.kz/article.php?article_id=88).

<sup>114</sup> "The Price of Relics," *Gazeta.kz*, August 8, 2006, <http://www.newspaper.kz/article.aspx?aid=2914>.

But this was an economically depressed area of the country, in the northern part of Jambyl oblast, which had suffered the environmentally despoiling effects of the Soviet-era phosphorous industry, and was a region with a history of labor unrest in the 1990s.<sup>115</sup> So against the best advice of oil and gas experts, in 2004 the government made the decision to develop a commercially unprofitable deposit, in part because of the costs of separating helium from the gas, and at a cost substantially higher than the first estimates for the project.<sup>116</sup> The development of Amengeldy field does not eliminate Kazakh dependence upon Uzbek gas it just relieves one small area of southern Kazakhstan from dependence on higher priced Uzbek gas. In fact, the problem for southern Kazakhstan is not just the price of Uzbek gas, but that it doesn't meet the demand for natural gas in the southern part of the country.<sup>117</sup>

This project does not affect a part of KMG that is being publicly traded, but it obviously contributes to the inefficiencies that have been characteristic of KazTransGas which is responsible for this project.

Similarly, there have been periodic export bans, which have disproportionately affected producers in the southern part of the country, where agriculture is most widely developed. Many of these export bans have occurred when subsidized fuel for agricultural was in short supply and producers were forced to sell to Kazakhstan's domestic refinery. They also have occurred in winter when there were local shortages of heating oil. Most of these bans have been designed to stop the export of aviation fuel, diesel and pet-

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<sup>115</sup> In 1997, ethnic Kazakh workers went on strike in Kentau for several weeks before the government agreed to pay back wages. Despite numerous deaths caused by the strikes, the government was slow to action. See Martha Brill Olcott, *Kazakhstan: Unfulfilled Promise* (Washington: Carnegie Endowment for International Peace): 81.

<sup>116</sup> "Amengaldy gas: has time run out," *Ekspert Kazakhstan*, March 14, 2001.

<sup>117</sup> "The Price of Relics," *Gazeta.kz*, August 8, 2006, <http://www.newspaper.kz/article.aspx?aid=2914>.

rol; the latter two in particular were marketed by KMG subsidiaries for higher prices in Kyrgyzstan than they were able to get on the Kazakh market.<sup>118</sup> In Kazakhstan, strong price controls still exist on fuel used in agricultural machinery, although prices for consumer consumption of automobile fuel is moving toward world prices, but not quickly enough to remove the differential of foreign export.

Many of the shortages were tied to PetroKazakhstan and the Shymkent refinery, which frequently found itself unable to meet the contracted supply to some eighty gas stations in Southern Kazakhstan Oblast.<sup>119</sup> KMG's control of the Shymkent refinery could lead to a better supply of oil products to the Southern Kazakhstan region, it will diminish the potential profitability of the Kumkol deposits (which were sold by PetroKazakhstan to CNPC, with KMG eventually getting a 33 percent interest), as their required deliveries to Shymkent will at minimum remain steady (at roughly a third of production), and could possibly increase.

### *Social Obligations*

KazMunaiGas, as well as all the other oil and gas companies operating in the country are forced to support a variety of social projects, both in the form of mandatory social obligations, of a sum specified in their production agreements, and in terms of "voluntary" obligations, for which they receive some tax breaks.

KMG has obligations to help develop cadre, to which ends they created a Center for the Development of Personnel, to provide the opportunity for employees to raise their

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<sup>118</sup> See for example "Kazakhstan bans gas exports, extends ban on diesel exports," *Times of Central Asia*, October 22, 2005; "Government re-imposes temporary ban on diesel export," *IntelliNews – Kazakhstan Today*, March 5, 2003; "Kazakhstan stopped export of fuel oil until March 1, 2004," *Ibris – News of Kazakhstan Financial Markets*, September 19, 2003; "Kazakhstan extends export ban on oil products," *Gazeta.kz*, February 7, 2006; "MP Chirkalin asks PM to introduce ban on export of liquefied gas," *Gazeta.kz*, October 18, 2006.

<sup>119</sup> "The Country Needs to Articulate a Solid Political Strategy for the Gas Market," *Ekspert Kazakhstan*, October 25, 2006, <http://www.expert.ru/printissues/kazakhstan/2005/22/>.

technical qualifications. They also have a “Young Specialist” program, and have worked with the Kazakh-British University to provide advanced training for their workers, and also have developed internship programs with foreign firms.<sup>120</sup>

KMG E and P is also subject to the State Procurement Law, like all other subsoil contract holders, which requires a tender for all goods, works and services worth \$31 thousand, including even the hire of external experts, which gives the government of Kazakhstan substantial ability to insure that local cadre and service providers get “sufficient” consideration. And of course, it is Kazakh regulatory agencies who will decide what “sufficient” consideration is.

KMG E and P, just like all subsoil use license and production contract holders is expected to sponsor social programs for the benefit of the local communities in which they operate, and many of these programs are enshrined in legally binding agreements with these localities. These include the construction of medical centers, rehabilitation and rest homes, orphanages, recreational facilities, and in some cases workers housing.

The company also makes lump sum payments to new retirees, and offers three metric tons of coal annually to every retired employee who lacks central heating, gives them a free subscription to a local newspaper and a free treat to a sanatorium once every three years. In addition they give retired women \$39 on international women’s day, \$78 on navruz, the same sum on the Day of Workers of the Oil and gas Complex, and also on Senior Citizen’s Day and Independence Day. They also provide a \$234 death benefit, and give the same sum on their 60<sup>th</sup>, 70<sup>th</sup>, 80<sup>th</sup> and 90<sup>th</sup> birthdays.<sup>121</sup> These are all Soviet-era benefits that have been continued.

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<sup>120</sup> KazMunaiGas, “Ecology and Worker Protection,” *KMG Website*, <http://www.kmg.kz/index.cfm?tid=45>.

<sup>121</sup> LSE, *KMG EP IPO*, 87

All subsoil license and production contract holders are also required to engage in training programs for the local workforce, and to increase the professional qualification of their existing work force through on the job training programs and a system of educational grants.

KMG spent \$80 million for the first five months of 2006, and in addition made a “voluntary” donation of another \$24.9 million for the same period.<sup>122</sup>

Ironically, though the company is obligated to provide a variety of social benefits for the communities in which it operates, and for its workers, even KMG E and P, the most western style of all the KMG subsidiaries, still lacks some forms of basic insurance. It has insurance covering certain production assets, some insurance for environmental damage, and for environmentally hazardous activities (up to \$136 thousand). It also has third party liability insurance. However it doesn’t carry insurance for business interruption, for damage done by sabotage or by terrorism.<sup>123</sup>

### *Environmental Protection*

NC KMG and KMG E and P are subject to the same environmental protection laws that other companies operating in Kazakhstan are. The companies have been fined for violations of the law, and do fight (sometimes successfully, sometimes not) these fines in court. This does not mean that they are treated identically with other companies.

Unlike what has sometimes been the case with large western projects in the country claims of environmental violations do not appear to be levied to gain concessions from KMG E and P—at least not by the national government. Local governments may in fact use this tool to force Astana to pay more attention to their concerns. KMG E and P

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<sup>122</sup> LSE, *KMG EP IPO*, 26.

<sup>123</sup> *Ibid*, 30.

have also never been threatened by the loss of exploitation license for environmental violations. But in general, the “environmental protection card” has been played with less vengeance than in Russia. Similarly, the regional courts which usually adjudicate these cases---which are still highly susceptible to “influence”---but not in a fully predictable fashion, may be favorably disposed to KMG E and P, because it is a government firm, but also, for much the same reason may be angry with them.

Regardless, KMG E and P recognizes that it has serious environmental problems in its operations, and in July 2005 it signed a Memorandum of Understanding with the Ministry of Environmental Protection, that KMG E and P assumed financial responsibility for bringing their practices up to current standards during the life of the contract, in return for not being fined for violations that predate their control of the production contracts.<sup>124</sup> But this does not exempt them from being fined by other national and regional bodies, for these preexisting problems; it does however make it very unlikely.

Nonetheless, KMG E and P estimated that it will have to spend approximately \$241 million between 2006 and 2025 to achieve environmental compliance. In 2005, the last year for which good estimates are available, the company spent \$14 million, for contaminated land restoration, for meeting air emissions standards, and for water treatment. The company’s largest environmental project, removing oil from contaminated water in Uzen, is not included in this, as independent contractors are currently doing this for free, in return for keeping the oily emulsion being removed from the water. KMG E and P may well be responsible for additional environmental projects should Kazakhstan ratify the Kyoto protocol, which is expected to occur in 2008.<sup>125</sup>

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<sup>124</sup> LSE, *KMG EP IPO*, 24.

<sup>125</sup> LSE, *KMG EP IPO*, 25.

## POLITICAL, SOCIAL AND CULTURAL FACTORS

It is a very subjective question whether corruption is likely to be a major factor in the future development of Kazakhstan's oil industry, and whether NC KMG is likely to be a major source of that corruption. Then it is even more difficult to know what role cultural and social factors play in supporting or explaining the degree of corruption that does exist.

In the early years of Kazakhstan's oil industry, there seems little doubt that corruption reached to the highest levels, as the investigations surrounding "Kazakhgate" revealed that the President of the country and two separate Prime Ministers were able to accumulate substantial off-shore holdings. While President Nazarbayev, publicly maintains that his Swiss bank accounts were just national funds being held in trust against a weak Kazakh banking system,<sup>126</sup> virtually no intelligent observer doubts that he and his family have accumulated a vast personal fortune, and one that was not based on wise investment of his salary as President.<sup>127</sup> The same can be said of each of the other senior officials who were engaged in one form or another in supervising the country's oil industry. Most knowledgeable observers of the Kazakh scene have a pretty good idea of what kind of "pay-off" each of these men received, whether in the form of shares of some state-held enterprise, land to dispose of, or some favorable off-shore business opportunity offered by an eager foreign investor. It is beyond the scope of this paper to recount all these numerous claims, and would risk charges of libel to attempt to do so.

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<sup>126</sup> See Olcott, *Second Chance*, 69; "Kazakhgate fire up election," *Eurasia Insight*, May 20, 2004, <http://www.eurasianet.org/departments/insight/articles/eav052004.shtml>.

<sup>127</sup> In my book on Kazakhstan I produced all the rumored assets of the Nazarbayev family at that time. Olcott, *Unfulfilled Promise*, 269.

More importantly, it is my opinion, that the same atmosphere of corruption no longer is as prevalent in the senior-most reaches of government, at least in so far as it affects the government's dealings with foreigners. The same, though, is not true of senior government officials dealings with Kazakhs, as who one knows and who one is friendly with is an important feature predictor of success, especially when formal tenders are not required. Corruption also seems to be quite pervasive in the mid-levels of government, in the ministries and regulatory agencies, in law enforcement and in the regional governments and judicial branches.

The court system is becoming more transparent, Soviet-era judges and procurators are being forced to go through retraining courses, and a great deal of attention is being paid to training of young lawyers, who are required to go through a system of state exams before being accredited. This last feature is quite important, as training in Kazakhstan's system of higher education is very uneven as to quality, and both admission and grades can still be purchased in certain institutions.

There is reason to be optimistic that the future will bring improvements in this regard. In the past few years the Kazakh government has become increasingly more aggressive in its public campaign against corruption. The legislative basis for fighting corruption has been strengthened, and lengthy prison terms have been awarded to several prominent judges arrested on corruption charges.<sup>128</sup>

Opposition figures complain, of course, that the same vigilance is not being applied to the president, to his family or to his inner circle. There is certainly a basis for their complaints, although one of the more odious figures close to the president, Nurtai

Abykayev,<sup>129</sup> former chairman of the Senate (and the acting president in case of presidential death or incapacity) lost his post in the January 2007 government reshuffling. Abykayev was one of the people rumored to have been responsible for murder of opposition leader Altynbek Sarsenbayev in 2006.<sup>130</sup>

Although both Sarsenbayev's death, and the rather mysterious "suicide" of Zamanbek Nurkadilov in 2005 were rumored to be because of their knowledge of corruption among the senior most elite,<sup>131</sup> there have been virtually no rumors as to what it was they were supposedly silenced to conceal.

In fact, President Nazarbayev seems increasingly more concerned about the nature of his legacy, and to that end, he appears interested in cleaning up the image of himself and his family. This is particularly true of the family's holdings in the oil industry. With the sale of Nelson Resources the Nazarbayev family no longer had any direct holdings in the oil production industry.<sup>132</sup> This left NC KMG as the only major Kazakh-owned oil company, and while the Nazarbayev family has the leadership position in running NC KMG,<sup>133</sup> it is less clear that it is being run to advance the personal interests of the Nazarbayev family, a point which we return to in the next section.

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<sup>129</sup> Abykyev was just recently named the Kazakh ambassador to Russia. He has held many posts close to the president, including those senior advisor and chief of staff.

<sup>130</sup> "Nursultan Nazarbayev is putting together a team of senior state officials to leave the country to," *Ferghana*, January 15, 2007, <http://enews.ferghana.ru/article.php?id=1795>.

<sup>131</sup> See "Mysterious Murder Mars Presidential Election Campaign," *Eurasia Insight*, November 11, 2005 or "Kazakh Opposition Wants Probe of Politician's Death," *RFE/RL*, November 14, 2005.

<sup>132</sup> "Lukoil/Lakshmi Mittal Deal," *Financial Times*, December 12, 2006.

<sup>133</sup> The sale of PetroKazakhstan also eliminated direct involvement of another group of formerly politically powerful Kazakhs (who had been part of the takeover attempt of Hurricane Hydrocarbons, before it became PetroKazakhstan) from the oil industry as well. See "Hurricane's Eyes Are on Kazakhstan," *Business Week*, March 25, 2002.

While the “first family” of Kazakhstan is certain to remain above public reproach, maligning them in the media is even a violation of Kazakh law,<sup>134</sup> the new Prime Minister Karim Massimov, appointed in January 2007, is likely to be even more aggressive about campaigning against corruption, than his predecessor. He is publicly committed to introducing administrative reforms that will make the administrative system less prone to corruption, and even has some western training in business and public administration.<sup>135</sup> At minimum, Massimov is committed to sharply streamline government, cutting back the number of state programs, projects and agencies, reducing the size of ministries, and speeding up the pace of reform of local governments, to make them more representative and more publicly accountable.

Part of this is obviously a “public relations” campaign to try and gain Kazakhstan the chairmanship of the OSCE for 2009, but the substantive reform programs being introduced by Prime Minister Massimov will certainly make Kazakhstan more foreign investment and business friendly. Massimov may make himself so unpopular that his tenure as prime minister proves a short one, but Nazarbayev’s decision to appoint him suggests that the reforms themselves are likely to survive the eventual “demise” of their implementer.

Corruption has long been endemic in Kazakhstan, and was an omnipresent feature of late Soviet-era life. But there is nothing in Kazakh culture that is particularly supportive of corruption, and at the same time the culture does not eschew corruption either.

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<sup>134</sup> Law No. 2818 of the Republic of Kazakhstan, “Concerning Mass Media,” January 27, 2004.

<sup>135</sup> Massimov graduated from Columbia Business School, and has a law degree from a Chinese University. He previously served as chairman of ATF Bank and Halyk Bank, and has been closely involved in Kazakhstan’s WTO ascension talks. “Kazakh President Names Perceived Reformer to Head Government,” *Business Online*, January 10, 2007.

Much has been written about the important role of “clan” in Kazakh politics,<sup>136</sup> but this author, at least, believes that the role of clan as understood in its literal sense, shared blood-ties to a sub-ethnic community is exaggerated. Moreover, this is a topic that this author has devoted over thirty years of study to. Ethnic Kazakhs were historically organized around three “hordes” or “zhuz,” the Great, Small and Middle Hordes.<sup>137</sup> Each horde was divided into clans, and the Great Horde, from which Nazarbayev traces had the greatest number of clans, hence its name. Unlike the Kyrgyz to the south, clan identity became attenuated during Soviet rule, largely because Soviet policies destroyed the pastoral livestock breeding economy upon which it was based.

In the late Soviet period the Kazakhs, like virtually all other ethnic and regionally based communities living in the U.S.S.R. developed strong patronage networks, some of which were based in part of the patrilineal descent systems. But Kazakhstan is a multi-ethnic country, and although ethnic Kazakhs are now predominant in the country’s political elite, virtually all of the country’s main political groupings include people from different clans and ethnic communities. Just like any other complex political system, a great many variables go into making a political patronage group. Increasingly shared ideology is becoming an important criteria affecting how political groupings are formed. Obviously personal trust is an important component but the foundation for this can be kinship, but just as important is long-term association, such as shared education, shared assignment abroad, or being long-term employees in the same industry or enterprise. For this reason there is now intrinsic reason why political reform will not work in Kazakhstan.

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<sup>136</sup> See, for example, Kathleen Collins, “The Logic of Clan Politics: Evidence for the Central Asian Trajectories,” *World Politics* 56, no. 2 (January 2004).

<sup>137</sup> Martha Olcott. *The Kazakhs 2<sup>nd</sup> Edition* (Stanford, Hoover Institution Press, 2005).

The next few years will decide the near and medium range prospects of political reform in Kazakhstan. Following the death of President Saparmurad Niyazov of Turkmenistan, in December 2006, all of Central Asia's leaders seem to have begun thinking about their mortality, and what the future of their country might become after their departure.

For the first time, the chairman of the Senate is someone with the stature not only to be interim president, but also would be of the stature to be president as well. Kasimzhomart Tokayev, long-time Foreign Minister (who also served as Prime Minister) was named to this post during the government shake-up of January 2007. This, with the appointment of Karim Massimov as Prime Minister, and seemingly pro-western Marat Tazhin as Foreign Minister, suggests that President Nazarbayev may well be serious about setting his country firmly on the path of becoming a European-style democracy before his departure.

Kazakhstan is not going to become a democracy overnight. It still lacks a free media, an independent judiciary, and a parliament with real powers. Its political party system is still in its infancy, with opposition parties seriously restricted in their access to the population. But there are already rumors of major constitutional changes coming in the next six to twelve months. Various options seem to be under consideration, including constitutional reform to increase the powers of parliament, and then holding immediate (preterm) parliamentary elections, with fewer restrictions on independent and opposition parties than were the case during the 2004 elections.<sup>138</sup> There are even rumors that President Nazarbayev will step down as President, and occupy an enhanced position as chairman of the Senate. Obviously, it is difficult to predict which if any of these changes will

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<sup>138</sup> OSCE report on elections in Kazakhstan: Final report on Parliamentary Elections in Kazakhstan, September 19 and October 3, 2004  
Presidential Elections, Needs Assessment Report, September 28, 2005.

occur, but any of them seem more likely than the country moving further toward an autocratic system.

## **GEOPOLITICS AND NC KMG**

Since the middle of the 1990s, Kazakhstan's leadership has made skillful use of its oil and gas wealth to try and secure an international position for the country that is greater than its relatively small population and very inauspicious geographic position would seem warranted. As already noted, President Nazarbayev has tried marketing his country as a "bridge" between Europe and Asia, and in fact the country has sought membership in virtually every Asian and European multilateral institution that it is eligible to join, while simultaneously playing an active role in the Shanghai Cooperation Organization (currently headed by a Kazakh), and the Collective Security Organization (organized by Russia). Kazakhstan has been a member of all the various economic communities that have been organized by Russia as well, and is quite close to completing its negotiations for WTO entry.

But while neighbors Russia and China would certainly have courted Kazakhstan with or without its oil and gas wealth, for the basic reasons of national security that develop from shared borders, it is hard to believe that Kazakhstan would have gotten the attention it has received in other European and Asian capitals if it lacked its fossil fuel resources. One of the ways that Kazakhstan sought to maximize its international position was to try and secure investment from major oil companies from most leading European and Asian companies. This is detailed in Appendix II which shows that Kazakhstan has gotten investment from U.S., Russian, U.K., Italian, French, Dutch, Chinese, Indonesian

and Japanese firms, either in production or in refining projects, while German bankers provide much of the financial support for Kazakhstan's banking system.

At first this attention took the form of state visits, and now, it might even get Kazakhstan the chairmanship of the OSCE, although even with Kazakhstan agreeing to ship oil through the U.S. government's pet BTC pipeline project Washington did not support Astana's OSCE bid, although it did finally agree to the postponement of a decision.

Kazakhstan's oil and gas wealth has also had a very mixed impact on Kazakhstan's regional position. It is the country's investment capital (the indirect product of its oil and gas income) that is making the country Central Asia's regional economic power. But no matter how powerful Kazakhstan becomes in the region, it will be unable to shape a regional oil and gas policy. Right now this is largely being done by Russia, and eventually it may be done by both Russia and China in concert. By comparison the U.S. and Europe are likely to remain in a position of trying to offer incentives to the Kazakhs and other Central Asians to ship through Azerbaijan and Turkey, or possibly eventually through Afghanistan and on through Pakistan to India, but it is hard to believe that they will be in a position to ever assert any kind of coordinated regional policy. By contrast Russia, China, and some ways even Iran all have more ability to influence developments, as they can facilitate direct transport of the region's fossil fuels.

Take for example the example of the question of the legal status of the Caspian Sea. Caspian delineation appears a foregone conclusion. Kazakhstan and Russia signed an agreement in 1998 (which covered mineral rights, not ownership of subsoil), and the Kazakhs signed with Azerbaijan in 2001, but still has not settled with Turkmenistan. Moreover, the absence of a treaty signed by all five of the Caspian littoral states means

that the prospects of an undersea pipeline to transport Kazakh and Turkmen oil and gas remains one supported by the U.S. and Azerbaijan, but by neither of the two states on the eastern shore of the Caspian, something which limits the potential expansion of either the BTC or BTE pipelines. Although, in reality it is likely that both Kazakhstan and Turkmenistan would like this option, neither feels confident enough to risk alienating Russia, which adamantly opposes this project, and which can cite the unresolved legal status of the Caspian as grounds to threaten retaliation in the face of any undersea pipeline project.

In fact, it has been more difficult for Kazakhstan to arrange transport for its oil (and gas) than for it to find foreign investment to exploit the country's reserves. The Kazakhs have found shipment through Russia difficult to arrange, having to fight for increases in quotas for the Transneft pipeline, and finding (as all CPC partners have) that the Russian bureaucracy has little interest in facilitating CPC expansion, as unlike every other pipeline that passes through Russian territory, they do not control it. The Kazakhs are nervous about becoming too economically interdependent with China, and some speculate that this is the reason that the Kazakh government introduced a moratorium on the sale of licenses in early 2007.<sup>139</sup> Without other sources of oil to add to the promised flows from Kazakhstan, the Chinese may find it uneconomical to build a major land pipeline across Kazakhstan. Similarly, for all the U.S. and European interest in seeing alternative pipelines develop, the idea of shipping across Iran, a practical favorite for the Kazakhs, has never been of higher priority in the western capitals than that of isolating Teheran.

While NC KMG has often been the voice through which the Kazakhs speak, their leadership has not been the source of these foreign policy decisions; it simply has become

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<sup>139</sup> "Kazakhstan Places Moratorium on Oil License Sales," *Kommersant*, January 22, 2007.

the vehicle for executing them. There is no evidence that NC KMG has any sort of independent position in terms of who they would prefer to work with among the various production or transportation partners that Kazakhstan can work with. IOC's give the NC KMG and its daughter companies access to western technology and greater exposure to western corporate practices. The company has made a commitment to operate internationally, but to date they have not been very successful.<sup>140</sup> On the other hand, they have successfully acquired a 50 percent stake in Kherson Oil Refinery and Ukraine and won the tender to complete the Odessa-Brody-Plotsk pipeline.<sup>141</sup> In addition, the company looks poised to join the Burgas-Aleksandroupolis project.<sup>142</sup>

By contrast Russian firms offer a very different set of advantages. They do not press the Kazakhs to adopt transparent business practices, and in fact, can help them effect transfer pricing advantages. For example, Transneft and Gazprom can help compensate KazTransGas and KazTrans Oil for higher transit fees by giving them other downstream advantages. This is in effect one of the gains KazTransGas hopes to eventually gain from the relationship with Gazprom in their joint venture with Gazprom, which is designed to allow both companies to profit from the refining of Karachaganak gas through the Orenburg Refinery. While this project has been slow to get off the ground (from the Kazakh perspective because Gazprom has not offered generous enough terms for the use of the underutilized Orenburg refinery, it potentially allows NC KMG to make

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<sup>140</sup> KMG tried unsuccessfully to bid in the tenders for Mazeikiu Nafta refinery in Lithuania, and the Czech refinery, Unipetrol. It is rumored to want to get back into the contest for Mazeikiu Nafta. See "KazMunaiGas Hopes to Participate in Unipetrol Tender," *Press-Club of Kazakhstan*, March 18, 2004; and "KMG is likely to get back to contest for Mazeikiu nafta," *Oil Review*, November 9, 2006.

<sup>141</sup> "KMG will complete construction of the Odessa-Brody, extending it to Plotsk," *Oil Review*, November 14, 2006; "Kazakhstan to construct refinery in Turkey," *Oil and Gas of Kazakhstan*, October 27, 2006.

<sup>142</sup> "KMG will become a participant of the Burgas-Aleksandroupolis project," *Oil Review*, November 23, 2006.

profit from the Karachaganak project that doesn't have to be shared with the western consortia developing the deposit. A similar arrangement may well emerge for the processing of associated gas in the Kashagan project. While the foreign partners in that project are building a gas processing plant (necessitated in part because of new Kazakh prohibitions against flaring of gas, even in on shore projects), the same foreign partners are not entitled to a share of the profits from the transport of gas. These will belong exclusively to KazTransGas, and to its Russian partner at the Kazakh border, Gazprom.

It is hard to see a scenario in which NC KMG becomes a major international actor. At most it will become a regional actor of some significance. Moreover, it is hard to know how much international weight the company will exercise after the departure (or passing) of President Nazarbayev. The country's foreign policy successes are really his successes, and its failures are his failures as well.

## **CONCLUSION**

The future shape of KMG is obviously unclear, and not just to analysts of the oil industry, but to those working in KMG and in Kazakhstan's government as well.

The company still must decide whether they wish to remain an operating company, and even if they do continue to want to retain the operating role in some projects, they will still have to decide how rapidly and how completely to sell off its stakes in Kazakhstan's various oil and gas projects. For the foreseeable future they will not be able to compete with potential foreign investors, either in terms of their technological base or in terms of the financial competitiveness of their operations.

From the point of view of financial liquidity of the firm, there will certainly be an argument for reducing their holdings in certain projects. This will provide money for fur-

ther downstream and foreign investments, those which would provide KMG continued access to energy assets for that point in time when the Kazakhstan's domestic production begins to decline. Furthermore, this would reduce, but would certainly not eliminate the income stream from the oil and gas sector for the Kazakh government, which will continue to earn royalties and tax payments from all the mature projects in the country.

The Kazakhs seem to believe that moving away from production and project management will slow capacity building among the Kazakh technical classes, and slow the development of ancillary industries related to fossil fuel development. But the creation of the Kazakh National Fund is intended in part to support the development of sectors of the economy that are not dependent upon resource extraction. And the continued reliance on NC KMG and the continued development of KMG E and P as an extraction and production company could make it more difficult for the government to insure economic transparency in the key sectors of the economy, and so work against the development of the very economic security that NC KMG is designed to provide.

Nonetheless, as this paper has shown, KMG served as a vehicle for Kazakhstan to work out and codify investment laws, trade rules, foreign investment rules, and systems of procurement and government accounting, and in this task it has been rather successful.

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World Politics

## APPENDIX

### APPENDIX I.

### MAPS OF KAZAKHSTAN'S OIL AND GAS DEPOSITS





Source: EIA, *Country Profile: Kazakhstan*, EIA Website, [www.eia.doe.gov/emeu/cabs/Kazakhstan/Background.html](http://www.eia.doe.gov/emeu/cabs/Kazakhstan/Background.html).

## APPENDIX II.

## KAZAKHSTAN: MAJOR OIL AND NATURAL GAS PROJECTS

## UPSTREAM

Name of Field/Project	Project Partners	Estimated Reserves	Projected Investment	Project Status
<b>CASPIAN SEA PROJECTS</b>				
<i>Kashagan E Kashagan W Kairan Aktoty Kalamkas</i>	<b>Agip Kazakhstan North Caspian Operating Company (Agip KCO):</b> <ul style="list-style-type: none"> <li>• Eni - 18.52%</li> <li>• Total - 18.52%</li> <li>• ExxonMobil - 18.52%</li> <li>• Shell - 18.52%</li> <li>• ConocoPhillips - 9.26%</li> <li>• KMG - 8.33%</li> <li>• Inpex - 8.33%</li> </ul>	<i>9 billion to 13 billion recoverable (up to 38 billion probable)</i>	<i>Originally costed at \$29 billion but estimates put final total approaching \$50 billion</i>	PSA. Exploration and Production. Production starting no sooner than 2009 (initial production slated for 75,000 bbl/d, max 1.2 million bbl/d by 2013)
<b>Kurmangazy</b>	<ul style="list-style-type: none"> <li>• KMG-50%*</li> <li>• Rosneft-50%</li> </ul> * - KMG in negotiations with Total.	N/A	N/A	PSA. Exploration.
<b>Tyub-Karagan</b>	<ul style="list-style-type: none"> <li>• KMG - 50%</li> <li>• Lukoil -50%</li> </ul>	N/A	N/A	PSA. Exploration. Lukoil financing 100% of the exploration.
<b>Atash</b>	<ul style="list-style-type: none"> <li>• KMG - 50%</li> <li>• Lukoil -50%</li> </ul>	N/A	N/A	Exploration contract. Exploration. Lukoil financing 100% of the exploration.
<b>Zhemchuzhiny (“Pearls” Block)</b>	<ul style="list-style-type: none"> <li>• Shell-55%</li> <li>• KMG-25%</li> <li>• Oman Oil Company-20%</li> </ul>	N/A	N/A	PSA. Exploration. Shell and Oman Oil Company financing 100% of the exploration.
<b>Makhambet</b>	<ul style="list-style-type: none"> <li>• Atyraumunaigaz – 100%</li> </ul>	N/A	N/A	PSA. Exploration.
<b>Bobek</b>	<ul style="list-style-type: none"> <li>• Atyraumunaigaz –</li> </ul>	N/A	N/A	PSA.

	100%			Exploration.
<b>Khvalynskoye</b>	<ul style="list-style-type: none"> <li>• “Caspian Oil&amp;Gas Company” JV:</li> <li>• KMG – 50%</li> <li>• Lukoil – 50%</li> </ul>	N/A	N/A	Negotiations. Russia's jurisdiction.
<b>Tsentralnoye</b>	<ul style="list-style-type: none"> <li>• KMG – 50%</li> <li>• “CentrCaspNeftegas” (Gazprom/Lukoil) – 50%</li> </ul>	N/A	N/A	Negotiations. Russia's jurisdiction.
<b>Abai</b>	<ul style="list-style-type: none"> <li>• KMG</li> <li>• Statoil</li> </ul>	N/A	N/A	Negotiations.
<b>Istatai</b>	<ul style="list-style-type: none"> <li>• KMG</li> </ul>	N/A	N/A	Negotiations.
<b>Darkhan</b>	<ul style="list-style-type: none"> <li>• KMG</li> <li>• Chinese Consortium headed by CNOOC</li> </ul>	N/A	N/A	Negotiations.
<b>"N" Block</b>	<ul style="list-style-type: none"> <li>• KMG – 100%*</li> </ul> <p>* - KMG in process of selecting a partner.</p>	N/A	N/A	Negotiations.
<b>Satpayev</b>	<ul style="list-style-type: none"> <li>• KMG</li> <li>• ONGC</li> </ul>	N/A	N/A	Negotiations.
<b>Zhambai South – Zabu-runie South</b>	<ul style="list-style-type: none"> <li>• KMG – 100%*</li> </ul> <p>* - KMG in sale process of 50% of “Zhambai” LLP to: Lukoil – 25% and Repsol – 25%.</p>	N/A	N/A	PSA. Exploration.
<b>Zhambyl</b>	<ul style="list-style-type: none"> <li>• KMG</li> <li>• Korean Consortium headed by KNOC</li> </ul>	N/A	N/A	Negotiations.

#### KAZAKHSTAN ONSHORE PROJECTS

<b>Aktobe</b>	<ul style="list-style-type: none"> <li>• CNPC Aktobemunaigaz (88%),</li> <li>• <b>Within Block ADA partners include:</b> <ul style="list-style-type: none"> <li>○ KNOC</li> <li>○ LGIC</li> <li>○ Vertom</li> </ul> </li> </ul>	1.17 billion barrels of oil	\$4.1 billion	Producing 116,660 bbl/d of oil ( 2005), 69.6 Bcf/y of natural gas (2005)
<b>Arman</b>	<p><b>Nelson Resources:</b></p> <ul style="list-style-type: none"> <li>• Canada-50%</li> <li>• Shell-50%</li> </ul>	10.8 million barrels of oil	--	Produced 3,600 bbl/d of oil, 852 thousand cubic feet (mcf) of gas in 2005
<b>Egizkara</b>	<ul style="list-style-type: none"> <li>• LG Internatinal Corp- 50%</li> <li>• Others, Unknown</li> </ul>	200 million barrels of oil		Exploration beginning in October 2006 with drilling starting in late 2007

<b>Emba</b>	<ul style="list-style-type: none"> <li>• KMG-51%</li> <li>• MOL Rt, Vegyepszer (Hungary)-combined 49%</li> </ul>	500 million barrels of oil	--	Producing 57,700 bbl/d of oil (2004); produced 3.1 Bcf of natural gas (2004)
<b>Karachaganak</b>	<p><b>Karachaganak Integrated Organization (KIO):</b></p> <ul style="list-style-type: none"> <li>• Agip (Italy)-32.5%</li> <li>• BG-32.5%</li> <li>• Chevron -20%</li> <li>• Lukoil-15%</li> </ul>	2.3-6 billion recoverable barrels of oil & gas condensate reserves; 16-46 Tcf of recoverable natural gas reserves	\$4 billion for Phase Two (completed in 2004)	Producing 202,900 bbl/d, 1.1 mmcf/d natural gas (2005), 70% of oil exported through CPC
<b>Karakuduk</b>	Lukoil	Total estimated proved plus probable reserves of approximately 63 million barrels	\$190 million through 200 with \$170 million expected between 2006-2010	Producing 10,076 bbl/d of oil; produced 4.8 mmcf/d natural gas (2005)
<b>Karazhanbas</b>	<p>Citic Canada Energy (100%)</p> <p>*KazMunaiGaz option to Acquire 50%</p>	400 million barrels of oil	\$250 million since 1997, \$120 million in 2005	Producing 44,800 bbl/d (2005), (80-90 thousand bbl/d planned in next 2 years); produced 1.8 mmcf/d natural gas (2005)
<b>Kazgermunai</b>	<ul style="list-style-type: none"> <li>• Petrokazakhstan-25%</li> <li>• KMG-50%</li> </ul>	100 million barrels of oil	\$300 million	Produced 37,300 bbl/d of oil; 32 mmcf/d of natural gas (2005)
<b>Kumkol (North)</b>	<ul style="list-style-type: none"> <li>• <b>Turgai Petroleum:</b></li> <li>• Petrokazakhstan -50%</li> <li>• Lukoil-50%</li> </ul>	97-300 million barrels of oil	--	Producing 60,000 bbl/d of oil, 18.3 mmcf/d of natural gas (2005), Legal dispute between PKZ and Lukoil has stopped production in the past
<b>Kumkol South and South Kumkol</b>	<ul style="list-style-type: none"> <li>• PetroKazakhstan Kumkol Resource (PKKR)</li> </ul>	116 million barrels of oil		Producing 62,000 bbl/d of oil, 18.1 mmcf/d of natural gas (2005); Development of export pipeline infrastruc-

				ture will allow for production growth
<b>Mangistau</b>	Mangistaumunaigaz (Kazmunaigaz subsidiary)	1.4 billion barrels of oil	--	Producing 113,200 bbl/d of oil, 33.3 mmcf/d of natural gas (2005)
<b>North Buzachi</b>	<ul style="list-style-type: none"> <li>• Lukoil-50%</li> <li>• CNPC-50%</li> </ul>	1 to 1.5 billion barrels of oil	Over \$800 million	Producing 15,000 bbl/d of oil, 4.5 mmcf/d of natural gas (2005), Accelerated development plan approved in 2004
<b>Tengiz</b>	<ul style="list-style-type: none"> <li>• <b>TengizChevroil (TCO):</b></li> <li>• Chevron -50%</li> <li>• ExxonMobil-25%</li> <li>• KMG-20%</li> <li>• LukArco (Russia)-5%</li> </ul>	9 billion barrels of oil	\$23 billion over 40 years	Producing 271,000 bbl/d of oil (2005); expected max production of 1 mill. bbl/d by 2012; produced 580 mmcf/d of natural gas in 2005
<b>Uzen</b>	Uzenmunaigaz (Kazmunai-gaz subsidiary) 100%	147 million barrels of oil	--	Producing 127,000 bbl/d of oil (2004), 29.8 Bcf of natural gas (Jan-Sep 2004), 30% improvement from 2003 from advanced technologies

Modified from EIA, "Kazakhstan: Major Oil and Natural Gas Projects," *EIA Website*, <http://www.eia.doe.gov/emeu/cabs/Kazakhstan/kazaproj.html>.

## TRANSPORT

Pipeline	Ownership	Length/Capacity	Cost/Investment	Notes
<a href="#"><u>CPC: (Tengiz-Novorossiysk Pipeline)</u></a>	<b>Caspian Pipeline Consortium (CPC):</b> <ul style="list-style-type: none"> <li>• Russia-24%</li> <li>• Kazakhstan-19%</li> <li>• Chevron -15%</li> <li>• LukArco-12.5%</li> <li>• Rosneft-Shell-7.5%</li> <li>• ExxonMobil-7.5%;</li> <li>• Oman-7%;</li> <li>• Agip/Eni (Italy)-2%</li> <li>• BG (U.K.)-2%;</li> <li>• Kazakhstan Pipeline Ventures-1.75%</li> <li>• Oryx-1.75%</li> </ul>	990 mile oil pipeline from Tengiz oil field in Kazakhstan to Russian's Black Sea port of Novorossiisk; Phase I capacity: 565,000 bbl/d; Phase II capacity: 1.34 million bbl/d (2015)	\$2.6 billion for Phase 1; \$4.2 billion total when completed	First tanker loaded in Novorossiisk (10/01); exported 450,000 bbl/d in 2004, Target expansion to to 1.3 million bbl/d
<b>UAS Pipeline (Arytau, Samara; Connecting with Russian Pipeline System)</b>	<ul style="list-style-type: none"> <li>• KazTransOil (KMG Subsidiary)-100% on Kazakh side of the border</li> </ul>	1,232 kilometres, from Uzen to Caspian port of Atyrau, crosses into Russia, linking with Transneft system at Samara. Capacity of approximately 1,100,000 bopd	--	Under 15-year transit agreement with Transneft, Kazakhstan will export at least 17.4 million tonnes per year (350,000 bopd) of crude oil using the Russian pipeline system.
<b>BTC (Baku-Tblisi-Ceyan Pipeline)</b>	<ul style="list-style-type: none"> <li>• BP-30.1%</li> <li>• SOCAR-10%</li> <li>• Chevron-8.9%</li> <li>• Statoil-8.7%</li> <li>• TPAO-6.5%</li> <li>• Total-5.0%</li> <li>• Eni/Agip-5.0%</li> <li>• Itochu-3.4%</li> <li>• ConocoPhillips-2.5%</li> <li>• Inpex-2.5%</li> <li>• Amerda Hess/Delta-2.4%</li> </ul>	1,040-mile route from Baku, Azerbaijan via Georgia to the Turkish Mediterranean port of Ceyhan;. The capacity will be upgraded to 1 million bbl/d sometime between 2008 and 2009.	--	Oil exports via BTC averaged roughly 210,000 bbl/d from June-September 2006, and volumes are expected to climb to 500,000 bbl/d by early-2007.
<b>China Pipeline (Atasu-Alashankou)</b>	<ul style="list-style-type: none"> <li>• Kazakhstan-50%</li> <li>• China-50%</li> </ul>	613-mile-long, 813 mm, pipeline from Atasu, in northwestern Kazakhstan, to Alashankou in China's northwestern Xinjiang region.	--	Crude oil reached the Chinese side on July 29, 2006, around two months behind schedule

Modified from EIA, "Kazakhstan: Major Oil and Natural Gas Projects," *EIA Website*, <http://www.eia.doe.gov/emeu/cabs/Kazakhstan/kazaproj.html>.

## APPENDIX III.

### SALES AND MARKETING OF KMG EP

	For the five months ended 31 May				For the year ended 31 December					
	2006		2005		2005		2004		2003	
	(million tonnes, except percentages)									
KMG TradeHouse AG										
Odessa . . . . .	1.4	37%	1.3	35%	3.0	32%	4.6	53%	2.4	31%
Primorsk . . . . .	—	—	—	—	—	—	—	—	0.8	11%
Yuzhnyi/Central Europe	—	—	—	—	—	—	—	—	0.1	1%
Buting . . . . .	—	—	—	—	0.2	2%	—	—	—	—
Novorossiysk . . . . .	0.6	16%	0.6	17%	1.5	17%	1.0	11%	0.4	6%
Esomet . . . . .	0.8	19%	0.8	20%	1.8	20%	0.3	4%	—	—
Odessa (Naflex, Unioil) . . . . .	—	—	—	—	—	—	—	—	1.3	16%
CIS countries . . . . .	—	—	—	—	—	—	0.7	8%	0.8	11%
Domestic market										
Atyrau Refinery . . . . .	1.1	28%	1.0	28%	2.6	28%	2.1	24%	1.8	24%
Shymkent Refinery . . . . .	—	—	—	—	0.1	1%	—	—	—	—
<b>Total . . . . .</b>	<b>3.9</b>	<b>100%</b>	<b>3.7</b>	<b>100%</b>	<b>9.2</b>	<b>100%</b>	<b>8.7</b>	<b>100%</b>	<b>7.6</b>	<b>100%</b>

## APPENDIX IV.

## EXPORT ROUTES AND SHIPMENTS

	2003	2004	2005	2006
CPC	16.3	<b>24.8</b>	<b>33.6</b>	<b>34.3</b>
UAS	<b>14.6</b>	<b>16.5</b>	<b>16.7</b>	--
China Pipeline	--	--	--	2.16
BTC (via tanker)	--	--	--	--
Total	<b>44.6</b>	<b>53.9</b>	<b>57.7</b>	--



## APPENDIX V.

## REFINERY PRODUCTION 2003-2006

Millions of Tons	2003	2004	2005	2006
<b>Atyrau</b>	2.5	3.2	3.9	4.1
<b>Pavlodar</b>	2.8	3.2	4.1	4.2
<b>Shymkent</b>	4.3	3.9	4.3	4.4
<b>Total</b>	<b>9.6</b>	<b>10.4</b>	<b>12.3</b>	<b>12.8</b>

Source: LSE, KMG E&amp;P IPO, p. 40.

## APPENDIX VI.

### SELECTED FINANCIAL INFORMATION FOR KMG EP

#### I. Consolidate Statements of Income and Cash Flow

##### Consolidated Statements of Income

	Five months ended 31 May			Year ended 31 December			
	2006	2006	2005	2005	2005	2004	2003
	(US\$ thousands)	(KZT thousands)		(US\$ thousands)	(KZT thousands)		
	(unaudited)	(unaudited)		(unaudited)	(audited)		
<b>CONTINUING OPERATIONS</b>							
Revenue							
Export:							
Crude oil . . . . .	1,168,910	150,286,721	104,690,882	2,257,904	300,030,298	203,059,607	146,167,659
Refined products . . .	0	0	651,491	4,903	651,491	6,791,761	3,347,074
Domestic:							
Crude oil . . . . .	101,577	13,059,758	0	52,159	6,930,889	94,638	3,153,951
Refined products . . .	32,252	4,146,619	13,681,276	246,930	32,812,045	18,487,681	19,641,750
Gas products . . . . .	12,223	1,571,511	1,408,663	30,720	4,082,068	3,886,963	2,905,790
Other sales and services	12,910	1,659,852	1,323,849	14,469	1,922,654	4,782,568	2,541,149
	1,327,872	170,724,461	121,756,161	2,607,085	346,429,445	237,103,218	177,757,373
Operating expenses . . .	(530,182)	(68,165,441)	(70,956,733)	(1,539,551)	(204,575,552)	(162,276,362)	(136,586,864)
Profit from operations . .	797,690	102,559,020	50,799,428	1,067,534	141,853,893	74,826,856	41,170,509
Finance (expense)							
income . . . . .	(32,498)	(4,178,210)	509,732	8,237	1,094,568	(3,436,830)	(2,228,285)
Profit before tax and minority interest . . .	765,192	98,380,810	51,309,160	1,075,771	142,948,461	71,390,026	38,942,224
Income tax expense . . .	(443,412)	(57,009,517)	(32,195,396)	(746,483)	(99,192,639)	(58,209,157)	(31,513,204)
Profit for the period from continuing operations . . . . .	321,780	41,371,293	19,113,764	329,288	43,755,822	13,180,869	7,429,020
<b>DISCONTINUED OPERATIONS</b>							
Profit for the period from discontinued operations . . . . .	0	0	701,563	11,447	1,521,130	283,718	74,211
Profit for the period . . .	321,780	41,371,293	19,815,327	340,736	45,276,952	13,464,587	7,503,231
Attributable to:							
Equity holders of the Company . . . . .	321,780	41,371,293	19,721,658	339,213	45,074,642	13,426,853	7,493,361
Minority interest . . . . .	0	0	93,669	1,523	202,310	37,734	9,870

##### Consolidated Statements of Cash Flows

	Five months ended 31 May			Year ended 31 December			
	2006	2006	2005	2005	2005	2004	2003
	(US\$ thousands)	(KZT thousands)		(US\$ thousands)	(KZT thousands)		
	(unaudited)	(unaudited)		(unaudited)	(audited)		
Net cash generated from operating activities . . . . .	203,383	26,148,964	26,687,846	564,823	75,053,723	60,494,214	45,211,534
Net cash used in investing activities . . . . .	(94,125)	(12,101,652)	(54,238,665)	(748,769)	(99,496,430)	(82,338,545)	(33,465,385)
Net cash (used in) from financing activities . . . . .	(24,037)	(3,090,452)	57,393,020	226,385	30,082,102	27,160,949	(5,080,542)

Source: LSE, KMG EP IPO, p. 13.

II. Capitalization

	As at 31 May 2006 (in millions)			
	Actual		As adjusted	
	KZT	US\$	KZT	US\$
Cash and cash equivalents <sup>(1)(3)(4)(5)</sup> . . . . .	30,327	250	166,382	1,370
Other current financial assets <sup>(2)</sup> . . . . .	60,361	497	60,361	497
Non-current financial assets <sup>(2)</sup> . . . . .	2,229	18	98,672	812
Current portion of long-term borrowings <sup>(4)</sup> . . . . .	19,129	157	20,998	173
Long-term borrowings, net of current portion <sup>(2)(4)</sup> . . . . .	41,990	346	142,481	1,173
Total long-term borrowings . . . . .	61,119	503	163,478	1,346
Share capital <sup>(1)(5)</sup> . . . . .	11,792	97	263,195	2,167
Retained earnings <sup>(3)</sup> . . . . .	203,757	1,677	185,732	1,529
Minority interest . . . . .	80	1	80	1
Total shareholders' equity . . . . .	215,629	1,775	449,007	3,696
Total capitalisation . . . . .	<u>276,748</u>	<u>2,278</u>	<u>509,246</u>	<u>4,192</u>

- (1) Assuming the receipt by the Company of the estimated net proceeds of the Global Offer of KZT250,382 million (US\$1,970 million), after deducting the underwriting commissions and estimated offering expenses payable by the Company.
- (2) Adjusted to reflect the issue of the Senior Notes (and subsequent transfer of all of the Senior Notes to the Company as payment in kind for Shares), the proceeds of which, together with an additional KZT24.4 billion, were lent to NC KMG in connection with financing the acquisition of its interest in KazGerMunai. See "Operating and Financing Review—Recent Developments—Bond Issue and Loan".
- (3) Adjusted to reflect the payment of a KZT18 billion special dividend which was approved by the Company's shareholders on 28 August 2006.
- (4) Adjusted in respect of a further US\$50 million advance payment from Esomet. See "Operating and Financial Review—Recent Developments—Esomet Arrangement".
- (5) Adjusted to reflect the pre-emptive offer of shares which was completed in August 2006.

Save for the adjustments reflected above there has been no material change in the total capitalisation or indebtedness of the Company since 31 May 2006.

The Company's share capital as of 31 December 2005 and as of 31 May 2006 consisted of 43,051,132 Shares and 4,117,699 preference shares.

Source: LSE, *KMG EP IPO*, p. 35.

## Appendix VII.

### Tax Structure and Examples of Contract Exposure

#### I. Tax Structure for two different types of contracts

Applicable taxes	Model 1 (EPT)	Model 2 (PSA)
<b>1. Special taxes and payments of subsurface user:</b>		
Bonuses	Yes	Yes
Royalty	Yes	No
Excess profits tax	Yes	No
Share of the production	No	Yes
Additional payment under PSA "Top Up Tax"	No	Yes
<b>2. Other taxes and obligatory payments to the budget, including:</b>		
Rent tax on export of crude oil and gas condensate	Yes	No
Excise on crude oil and gas condensate	Yes	No
Land tax	Yes	No
Property tax	Yes	No
Environmental fees	Yes	Yes
Other fees (e.g. fee for the use of radio frequency spectrum, fee for the use of navigable waterways)	Yes	Yes
Other taxes and payments	Yes	Yes

Source: Ernst and Young, *Kazakhstan 2006*, p. 22.

#### II. Royalty Calculation

Volume of accumulated oil production, including gas condensate, for each calendar year (thousand tons)	Royalty rate
Up to 500	2.0%
From 500 to 1,000	2.5%
From 1,000 to 1,500	3.0%
From 1,500 to 2,000	3.5%
From 2,000 to 2,500	4.0%
From 2,500 to 3,500	4.5%
From 3,500 to 4,500	5.0%
From 4,500 to 5,000	5.5%
More than 5,000	6.0%

Source: Ernst and Young, *Kazakhstan 2006*, p. 12.

## III. Economic Rent Tax

<b>Market price (USD/bbl)</b>	<b>Rate</b>
Less than 19	0%
From 19 to 20	1%
From 20 to 21	4%
From 21 to 22	7%
From 22 to 23	10%
From 23 to 24	12%
From 24 to 25	14%
From 25 to 26	16%
From 26 to 27	17%
From 27 to 28	19%
From 28 to 29	21%
From 29 to 30	22%
From 30 to 31	23%
From 31 to 32	25%
From 32 to 34	26%
From 34 to 36	28%
From 36 to 37	29%
From 37 to 38	30%
From 38 to 40	31%
More than 40	33%

Source: Ernst and Young, *Kazakhstan 2006*, p. 16.

IV. Sample EPT Calculation under current regime

#	Description	Example 1	Example 2
<b>Assume:</b>			
1	Accumulated income, USD	1,200	1,400
2	Accumulated expenses, USD	1,000	1,000
3	Ratio of accumulated income to accumulated expenditures	1:2	1:4
4	Sales Income for a tax year, USD	100	100
5	Deductible Costs for a tax year, USD	70	30
6	Taxable Income, USD	30	70
7	CIT, USD	9	21
8	Net Income, USD	21	49
<b>Then:</b>			
9	20% of deductions, USD (line 5 times 20 %)	14	6
10	Tax base, USD (line 8 less line 9)	7	43
11	EPT rate (in accordance with Article 308)	10	30
12	EPT amount, USD	0.7	12.9

Source: Ernst and Young, *Kazakhstan 2006*, p. 17.

## V. Two Sample KMG EP Contracts

## Contract No. 40

<i>Contract Area</i>	Contract No. 40 covers 366.26 square kilometres and is divided into two fields, Uzen and Karamandybas. The fields are located in the Karakiyansky region of Mahgistan Oblast.								
<i>Term Expires</i>	29 May 2021.								
<i>Royalty Payments</i>	Monthly payment to the state budget of a fixed royalty, equal to 3% of the volume of extracted hydrocarbons, calculated on the basis of the average price for the reporting period, payable during the term of the contract.								
<i>Corporate Income Tax</i>	Monthly payment of corporate income tax at a fixed rate of 30% of the Company's taxable income, each year during the term of the contract.								
<i>Value Added Tax</i>	Fixed at 20% of the value of taxable turnover.								
<i>Excess Profit Tax</i>	Annual payment of excess profit. Excess profit tax ("EPT") is calculated at the following rates: <table border="1" data-bbox="581 730 1372 884"> <thead> <tr> <th>Real rate of return</th> <th>Rate</th> </tr> </thead> <tbody> <tr> <td>less than 20%</td> <td>0%</td> </tr> <tr> <td>more than 20% but less or equal to 25%</td> <td>30% of the profit exceeding 20%</td> </tr> <tr> <td>more than 25%</td> <td>50% of the profit exceeding 25%</td> </tr> </tbody> </table>	Real rate of return	Rate	less than 20%	0%	more than 20% but less or equal to 25%	30% of the profit exceeding 20%	more than 25%	50% of the profit exceeding 25%
Real rate of return	Rate								
less than 20%	0%								
more than 20% but less or equal to 25%	30% of the profit exceeding 20%								
more than 25%	50% of the profit exceeding 25%								
<i>Property Tax Quarterly</i>	payment to the relevant local budget at a fixed rate of 0.5% of the residual book value of main production and non production assets, payable during the term of the contract.								
<i>Road Use Tax</i>	Monthly payment to the relevant local budget at a fixed rate of 0.5% of the volume of the hydrocarbon sales revenues, payable during the term of the contract.								
<i>Land Fee</i>	Quarterly payment to the relevant local budget.								
<i>Employment Fund Fee</i>	Monthly payment to the state budget at a fixed rate of 12% of Employees' salaries and wages payable by the Company during the term of the contract.								
<i>Social Insurance Fund Fee</i>	Monthly payment into the relevant local budget at a fixed rate of 30% of the employee's salaries and wages fund, payable by the Company during the term of the contract.								
<i>Social Programmes</i>	The Company's participation in the development of social infrastructure in the contractual area is stipulated in the Company's work programmes.								
<i>Environmental Fund Fee</i>	Quarterly payment of a fee into the Kazakhstan Environmental Fund at annual rates set by local authorities depending on factual emissions of pollutants during the term of the contract.								
<i>Training of Personnel</i>	No less than one per cent of annual capital expenditure.								
<i>Other Provisions</i>	Contract No. 40 requires the Company to shut down all wells drilled on the Uzen and Karamandybas fields that are no longer used by the Company in its operations.								

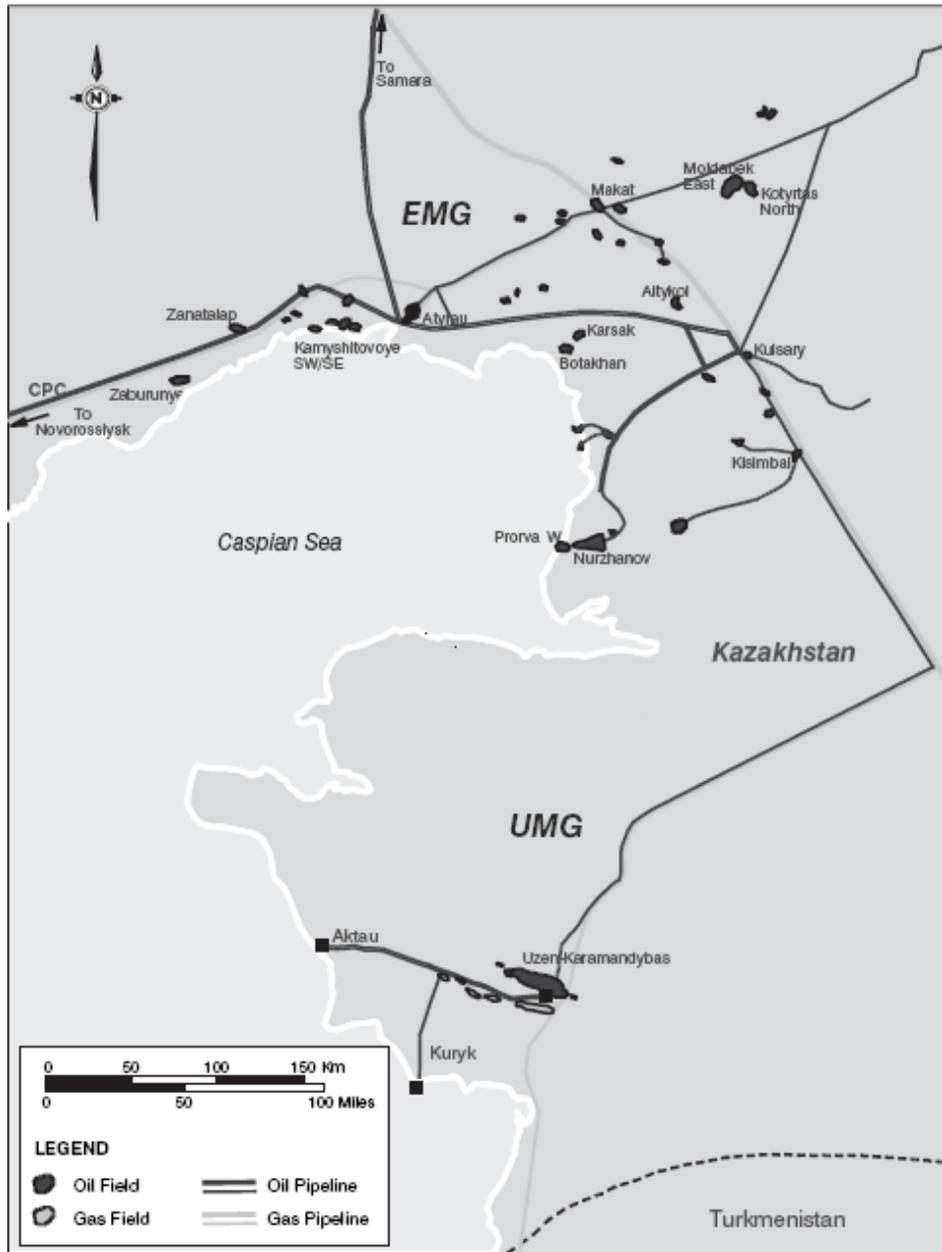
## Contract No. 61

<i>Contract Area</i>	Contract No. 61 covers the 9.2 square kilometre area that comprises the South Eastern Novobogatin-skoye Field which is located 40 kilometres to the west of the Ural river in the south eastern part of the Volga Ural interfluvium.
<i>Term Expires</i>	28 May 2017.
<i>Royalty Payments</i>	Annual payments of a fixed royalty, equal to 6% of the volume of extracted oil, each year during the term of the contract. The Government reserves the right to change the monetary form of the royalty payments to payments in kind, with 60 days prior notice to subsoil user.
<i>Corporate Income Tax</i>	Monthly payments of corporate income tax at a fixed rate of 30% of the Company's taxable income during the term of the contract.
<i>Value Added Tax</i>	Fixed at 20%.
<i>Excess Profit Tax</i>	Annual payments on the excess profit depending on the Company's internal rate of return.
<i>Property Tax</i>	Quarterly payments of property tax to the relevant local authorities at a fixed annual rate of 1.0% of the residual book value of main production and non production funds payable during the term of the contract.
<i>Road Use Tax</i>	Monthly payments of road use tax to the relevant local authorities at a fixed rate of 0.5% of the value of hydrocarbon sales revenues, each year during the term of the contract.
<i>Land Tax</i>	Quarterly payments to the relevant local authorities of a land tax.
<i>Employment Fund Fee</i>	Monthly payments into the relevant local budget at a fixed rate of 2% of the salaries and wages fund, payable in the course of the contract.
<i>Social Insurance Fund, Obligatory Medical Insurance Fund and Pension Fund Fee</i>	Monthly payments into the relevant local budget at a fixed rate of 30% of the salaries and wages fund, payable in the course of the contract.
<i>Social Programs</i>	The Company is required to participate directly in social infrastructure development in accordance with the feasibility study.
<i>Environmental Fund Fee</i>	Quarterly payments into the Kazakhstan Environmental Fund at annual rates set annually by local authorities depending on factual emissions of pollutants during the term of the contract.
<i>Training of Personnel</i>	/ Not less than 1% of total expenditure.
<i>Signing Bonus</i>	Payment of an amount of US\$15,000 within 30 days from the signing date.
<i>Production Bonus</i>	Payment of US\$50,000 once production volume reaches 200,000 tonnes, 400,000 tonnes and 600,000 tonnes.

Source: LSE, *KMG EP IPO*, pp. 96-100

APPENDIX VIII.

KAZMUNAIGAS EXPLORATION AND PRODUCTION RESERVES:  
UZENMUNAIGAS AND EMBAMUNAIGAS



### **The UMG Fields**

The UMG fields represent approximately 75% of the Company's total proved plus probable oil reserves and are comprised of the following fields:

- Uzen field (oil and gas);
- Karamandybas field (oil and gas);
- Zhetybai South field (gas and gas condensate);
- Tenge West field (gas and gas condensate);
- Aktas field (gas and gas condensate);
- Tasbulat field (gas and gas condensate); and
- Eastern Uzen (gas).

#### **Uzen Field**

The Uzen field is the third largest oilfield in Kazakhstan according to 2005 annual crude oil production volumes. The Uzen field was discovered in 1961 and has been in production since 1965. It is the Company's largest oil field both in terms of crude oil reserves and production volume and comprised approximately 72% of the Company's total proved plus probable oil reserves and 22% of the Company's total recoverable gas reserves.

#### **Karamandybas Field-**

The Karamandybas field was discovered in the mid-1960s to the west of the Uzen field. The Karamandybas field has been producing since 1973. Independent experts estimate that it comprises approximately 3% of the Company's total proved plus probable oil reserves and the Company estimates that it could comprise 18% of the Company's total recoverable gas reserves, according to Kazakhstan methodology. The Company has estimated the field has reserves of 3 million cubic metres of gas.

**Other Gas and Gas Condensate Fields-**

In addition to the Uzen and Karamandybas fields, the UMG fields contain gas and gas condensate reserves at the Zhetybai South, Tenge West, Aktas and Tasbulat and Eastern Uzen fields. These gas and gas condensate fields are used to supply the Mangistau region in Kazakhstan. Using Kazakhstan methodology the Company estimates that, as of 31 December 2005, these fields comprised approximately 60% and 100% of the Company's total gas and gas condensate reserves, respectively. KMG E&P estimate that, using Kazakhstan methodology, recoverable reserves at these fields were 9.7 billion cubic metres of gas and 1.6 million tonnes (12.7 million barrels) of gas condensate.

**EMG fields**

The EMG fields comprise a total of 37 oil fields located around the northern and eastern shores of the Caspian Sea. Thirty-five of the EMG fields are in production and the two remaining fields, the Sagiz and Tazhigali fields, are shut in due to depletion and sea water flooding. Of the producing EMG fields, the following eight fields are the largest in terms of reserves and production volume:

- Kenbai (Moldabek East/North Kotyrtas)
- Kamyshitovoe South-West
- Zaburunye
- Zhanatalap
- Nurzhanov
- Botakhan
- Makat East
- Kamyshitovoe South-East

### **Kenbai (Moldabek East/North Kotyrtas)**

The Kenbai field was discovered in 1986 and has been producing since 1996. As of 31 December 2005, proved plus probable oil reserves at the Kenbai field were 4.7 million tonnes (33.6 million barrels), which accounted for approximately 2.3% of the Company's total proved plus probable oil reserves.

### **Kamyshitovoe South-West**

The Kamyshitovoe South-West field was discovered in 1967 and has been producing since 1972. As of 31 December 2005, proved plus probable oil reserves at the Kamyshitovoe South-West field were 6.3 million tonnes (47.3 million barrels), which accounted for approximately 3% of the Company's total proved plus probable oil reserves.

### **Zaburunye**

The Zaburunye field was discovered in 1982 and has been producing since 1989. As of 31 December 2005, proved plus probable oil reserves at the Zaburunye field were 3.9 million tonnes (27.4 million barrels), which accounted for approximately 1.9% of the Company's total proved plus probable oil reserves.

### **Zhanatalap**

The Zhanatalap field was discovered in 1968 and has been producing since 1974. As of 31 December 2005, proved plus probable oil reserves at the Zhanatalap field were 4.5 million tonnes (32.4 million barrels) of crude oil, which accounted for approximately 2.2% of the Company's total proved plus probable oil reserves.

### **Nurzhanov**

The Nurzhanov field was discovered in 1964 and has been producing since 1967. As of 31 December 2005, proved plus probable oil reserves at the Nurzhanov field were 8.4 million tonnes (60.6 million barrels), which accounted for approximately 4% of the Company's total proved plus probable oil reserves.

**Botakhan**

The Botakhan field was discovered in 1980 and has been producing since 1981. As of 31 December 2005, proved plus probable oil reserves at the Botakhan field were 2.7 million tonnes (20 million barrels), which accounted for approximately 1.3% of the Company's total proved plus probable oil reserves.

**Makat East**

The Makat East field was discovered in 1988 and has been producing since 1993. As of 31 December 2005, proved plus probable reserves at the Makat East field were 3.9 million tonnes (29.2 million barrels) of crude oil, which accounted for approximately 1.9% of the Company's total proved plus probable oil reserves.

**Kamyshitovoe South-East**

The Kamyshitovoe South-East field was discovered in 1982 and has been producing since 1987. As of 31 December 2005, proved plus probable reserves at the Kamyshitovoe South-East field were 3.1 million tonnes (22 million barrels), which accounted for approximately 1.5% of the Company's total proved plus probable oil reserves.

Source: KazMunaiGas Exploration and Production, "Oil and Gas Reserves," *KMG EP Website*, [http://eng.kmgep.kz/our\\_business/oil\\_and\\_gas\\_reserves](http://eng.kmgep.kz/our_business/oil_and_gas_reserves).



APPENDIX IX.

KMG STRUCTURE AND ASSETS

