Towards good practice in the oil and gas contracting chain: Kazakhstan country report[1]

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1. Introduction

This report is a Kazakhstan country contribution to a research project exploring the environmental and social performance of local contractors in the oil and gas supply chain. The project has focused on oil and gas supply chains in Russia (focusing on Russian Arctic regions and Sakhalin Island) and Kazakhstan (Atyrau Oblast principally) supplemented by a range of discussions and desk-based research on the practices of oil companies and contractors based in the UK and Norway.

This report is based on desk research and discussions with officials, businesses and non-governmental organisations in Atyrau, Astana and Almaty. Conversations with stakeholders in Atyrau took place over the period 9th-18th June 2007. A questionnaire survey of 8 local contractors (with 5 responses received) was carried out during July and August 2007.

The report is intended to provide a primer on the kinds of issues that may need to be addressed if the positive social and environmental performance of Kazakhstani contractors in the oil and gas sector is to be maximised.

The oil and gas sector in Kazakhstan is both relatively closed and relatively open. It is difficult for 'outsiders' to obtain hard data about standards applied in supply chain contracts across the sector, much less to copies of the contracts themselves. However, informally information flows freely across the bars and cafes frequented by oil and gas industry executives.

Much of the analysis in this report is based on anecdotal information which cannot be conclusively verified. We have made a note of such information where in our judgment it provides helpful indications of wider perceptions about the issues addressed in the report. Inevitably, in a report that places such emphasis on this kind of information, it is easy to dismiss these insights as 'unsubstantiated' or 'incorrect'. That would be to miss the point. We have sought faithfully to reproduce the essence of the points that we have heard. We do not suggest that all such remarks are objectively 'correct' – rather, that they point to issues or dilemmas that need to be addressed.[2]

[1] Important note: except where specifically indicated, information in this report is given as at November 2007. The report was finalised in 2009 (date for citation).
[2] All quotes are approximate, intended to convey the essential flavour of points raised during consultations.

The report is intended to stimulate discussion on what might be done for the future to enhance the environmental and social performance of Kazakhstani contractors in the country's oil and gas sector. It also highlights key outstanding issues relating to the challenge of building local economic content. It addresses some of the issues in the 'enabling environment' for these goals to be attained and raises questions about the balance of roles and responsibilities as between operators, major contractors and suppliers lower down the supply chain.

Many people reading this report will already be familiar with Kazakhstan and the country's oil and gas sector. With apologies to them, we have tried to provide enough basic background information to allow readers with a wider interest in business and sustainable development, or supply chain management, or indeed the oil and gas sector, to form their own judgment on the issues we raised.

The remainder of this report has the following structure:

- Section two contains a thumbnail sketch of the oil and gas sector in Kazakhstan for those who are not familiar with it
- Section three introduces some of the key issues relating to the oil and gas sector in Atyrau, where field-based research for this report was completed
- Section four highlights a range of stakeholder perspectives on Kazakhstan's oil and gas sector
- Section five outlines key policy frameworks relevant to regulation of the oil and gas sector in Kazakhstan
- Section six summarises our findings on environmental, health and safety, local content and wider management processes in the oil and gas contracting chain
- Section seven highlights the most important barriers to entry in the oil and gas supply chain for local contractors
- Section eight highlights strategies that different actors can use to overcome barriers and constraints and incentivise good performance
- Section nine addresses the problem of corruption, and
- Finally, section ten draws overall conclusions

The original language of the report is English.

2. Overview of the oil and gas sector in Kazakhstan

Kazakhstan is the ninth largest country in the world, covering a land area of 2,669800 km2[3] –or roughly the size of Western Europe. Its population is around 15 million.

Hydrocarbon revenues are very important to the country's economy. According to a 2005 World Bank report, they contribute some 30 per cent of GDP and half of all government revenues[4]. However, the percent of the total workforce employed in the oil and gas sector is much less than in the agricultural sector. The Human Development Index (UN HDI) ranks Kazakhstan as 79th out of 177 countries on a set of key human development indicators[5], with particular challenges in quality medical care, infant mortality, life expectancy and incidence of poverty.

[3] Kazakhstan at a Glance, 2007, available online via http://www.kazakhstanembassy.org.uk/cgi-bin/index/40

[4] *Getting Competitive, Staying Competitive: The Challenge of Managing Kazakhstan's Oil Boom*, World Bank Report no.30852, Country Economic Memorandum, The World Bank Group, 2005

[5] http://www.undp.kz/

According to a 2007 Government country overview, oil reserves are 32.5 billion barrels (twice as much as the North Sea), with projected oil reserves of 100-110 billion barrels by 2015. If realised, these figures would place Kazakhstan in the world's top five countries in terms of reserves. Gas reserves are estimated at 3 trillion cubic metres, with projected reserves of 5 trillion cubic metres by 2015.[6] The country's state-controlled oil company, KazMunaiGas, was listed on the London Stock Exchange in 2006.

Kazakhstan hosts three 'super-projects': Tengiz and Karachaganak are onshore projects which together produce some 1.3million barrels of oil a day.[7] Kashagan, an offshore project in the North Caspian Sea, has not begun production. Kazakhstan's oil reserves have been exploited since the closing years of the nineteenth century. But it was only in the late 1970s and beyond that today's super-fields began to be discovered.

Karachaganak is one of the world's largest oil and gas condensate fields. The field covers an area of over 280 square kilometres in the North West of Kazakhstan (the nearest towns are Aksai and Uralsk), with reserves of 1,200 million tonnes of oil and 1.3 trillion cubic metres of gas.[8] Development of the field is governed by a forty-year Production Sharing Agreement signed in 1997. Operating company KPO (Karachaganak Petroleum Operating) is a joint venture between BG Group, ENI, Chevron and Lukoil. The current joint operators of the field are British company BG Group and Italian Eni. The field was discovered in 1979, and production began in 1985, with gas and condensate exported through a 130km pipeline to a processing plant in Orenburg,[9] at one time capital of Kazakhstan but today located in Russia.

In March 2008, a Kazakhstan court fined the Karachaganak consortium KPO group USD15million for unauthorised gas emissions through gas flaring, in a dispute which began in 2007. KPO's Karachaganak project is jointly operated by BGplc and ENI, with other partners including Lukoil and ChevronTexaco. There were concerns that the fine might presage moves by KazMunaiGas to take a greater share in the project.[10]

To the South of Karachaganak, the huge offshore **Kashagan project** (boasting commercially exploitable reserves of between 9-16 billion barrels of oil) has been beset by delays and cost overruns. The Kashagan field is itself part of the Kazakhstan sector of the Caspian Sea. The operator of all operations in this sector from 2001 was Agip-KCO, a wholly owned subsidiary of Italian ENI. Seven international companies have a stake in the sector under the North Caspian Sea Production Sharing Agreement.

In summer 2007, continued delays and cost overruns triggered government moves to renegotiate the project's production sharing agreement. This was accompanied by a forced three-month cessation of operations ordered by then Environment Minister Nurlan Iskakov on grounds of infringement of environmental requirements.[11] At the

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[6] Kazakhstan at a Glance, 2007, available online via http://www.kazakhstanembassy.org.uk/cgi-bin/index/40

[7] http://www.reuters.com/ 30th July 2007

[8] www.kpo.kz

[9] http://www.kpo.kz/cgi-bin/index.cgi/19, accessed 31st August 2007

[10] See Reuters reporting of 20th March 2008 at http://www.reuters.com/article/companyNews/idUSL2010489220080320

[11] *Kazakhstan Halts Work at Kashagan oil field* Financial Times, August 27 2007, available online at http://www.msnbc.msn.com/id/20459193/ visited 31st August 2007

end of September 2007, the Majilis (Kazakhstan's Parliament) approved amendments to the subsoil use law, to provide for contract renegotiation on 'national security' grounds. The change was believed to be designed to put additional pressure on the partners in AGIP-KCO.[12]

Following the conclusion of initial contract renegotiations in January 2008, state oil and gas company KazMunaiGas increased its share in the Kashagan project from 8.33 percent to 16.81 percent, with each of the major foreign partners surrendering part of their stake and reportedly agreeing to pay up to USD5 billion as compensation for lost profits due to cost overruns and significant delays in commercial production.[1] Final negotiations concluded in October 2008, as a result of which, according to an Agip press release of 31 October 2008,[13] the joint venture partners agreed changes including revised operating responsibilities at different stages of the project. KazMunaiGas will take on an increasing role in the project and will be involved in each step of its development.

Importantly, the agreement envisages the creation of a new joint operating company comprising all the co-venturers with their respective participating interests. The new company will take over the responsibilities which are currently with Agip KCO as the sole operator of the North Caspian Sector Production Sharing Agreement. The Managing Director of the new joint operating company NCOC will be on rotation among the Partners and this role is initially fulfilled by a Total executive while the Deputy Managing Director is a KMG executive. The NCOC will be staffed by representatives of all partner companies and will be run largely in line with the Total Company management system. Transfer of operatorship from Agip KCO to NCOC has taken place in January 2009.

A number of technological challenges – environmental and otherwise - affect the Kashagan project and hence the structure of its contracting chain. The environmental sensitivity of the North Caspian Shelf, its shallow but fluctuating water levels, and climatic extremes that see temperatures plummet to as low as minus 40 degrees centigrade in winter and plus forty in the summer, all bring formidable environmental and technical challenges. On the environmental side, activists have for some time blamed seal deaths [and overall degradation of biodiversity] in the North Caspian Sea on oil operations – but it has been hard to identify which operator, if any, has been responsible: several (including the state oil company KazMunaiGas) operate there, and the government of Kazakhstan has in the past suggested that the seal deaths might have been a result of a 'seal plague.'[14]

Agip-KCO stresses participation of Kazakhstani companies in its basic mission statement. It describes its mission as "to explore and develop the North Caspian Sea PSA contract area in an economically and environmentally sound manner while increasing development opportunities for local communities, maximizing the participation of Kazakhstani companies in operations and generating value for the Consortium".

The **Tengiz** oil field was discovered in 1979, with recoverable reserves of between 6-9 billion barrels of oil. The initial Tengiz infrastructure was largely designed by

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[12] See http://www.atimes.com/atimes/Central_Asia/JB13Ag01.html

[13] http://www.agipkco.com/wps/wcm/connect/agip+kco/AgipKCO+EN/Home/About+Agip+KCO/News/Kashagan+project+Final+Agreements+and+Creation+of+the+North+Caspian+Operating+Company?id=79d9fc004b94f96c8e7a9e263a1de0af&pagedesign=Common/ContentPrintStyle

[14] *Panorama, August 27, 2007; Khabar, August 21, 2007*

Russian technical institutes. But a consortium of western contractors built the processing plant for the Tengiz oil field, including Lurgi, Litwin and Lavalin. Today, the project is run under a forty-year ‘project agreement’ (not a production sharing agreement) which was signed in 1993[15] in the early days of Kazakhstan’s independence. The operator is US Chevron (50%), and joint venture partners include LukArco (5%), ExxonMobil (25%) and the Republic of Kazakhstan (20%).

The history of relations between the Government of Kazakhstan and TengizChevroil has not been smooth. In late 2002, the regional oblast (government) fined TCO USD71million in respect of environmental pollution due to the stockpile of sulphur associated with production from the project. Whilst liability in the eyes of government and the public is assigned to operators, operations related to storage and management of the sulphur are carried out by contractors. Rightly or wrongly, many on the industry side feel that the fine was a response to changes in the government’s overall revenue management framework, which reduced the revenues payable directly to the regional government. .

The website www.hydrocarbons-technology.com is typical of this sentiment:

> *“This [fine] occurred because of changes in the way the central government collects taxes. In previous years some of the taxes were paid directly to the regional government where Tengiz is based.*
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> *The central government decided in 2002/2003 that all taxes should first be paid to the capital, Astana. Following this the Atyrau Oblast realised it faced a shortfall. They then had the idea of suing TengizChevrOil for damaging the environment. The fine was imposed for sulphur pollution*”.

The fine was reduced on appeal to the Supreme Court to USD 7million in 2003.[16] In 2007, environment minister Nurlan Iskakov threatened renewed fines in respect of the annual 1.6 million tonnes of sulphur generated at the site, in addition to the 9 million tonnes already accrued there.[17] Since the time of our research for this report, this resulted in a further fine of USD609million which was imposed in October 2007,[18] but later halved on appeal.

A Commission for sulphur management has been established, with close government monitoring. The Commission includes representatives of the Ministry of Environment, Ministry of Energy, Atyrau Akimat and KazMunaiGaz. At the time of our interviews in the Summer of 2007, sulphur management remained an important issue in the overall relationship between the state and the operator. Some local residents and business people felt that the 2003 fine was justified and that tough action was warranted. In the regional Akimat, sulphur was considered the number one environmental issue.

3. Oil and gas in Atyrau

Field-based research for this report was carried out in June 2007 in the city of Atyrau, in the West of Kazakhstan some 30km from the Caspian Sea. Atyrau is Kazakhstan’s oil capital. The shadow of the industry is everywhere. The headquarters of TengizChevroil are an ultra-modern monument to the huge Tengiz field. The bar of

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[15] http://pages.stern.nyu.edu/~jmei/homejp/lukoil.pdf visited 31st August 2007
[16] http://www.reuters.com/article/companyNewsAndPR/idUSL1690738820070216
[17] http://www.reuters.com/article/companyNewsAndPR/idUSL1690738820070216
[18] See http://www.globalinsight.com/SDA/SDADetail10773.htm

the smartest hotel in town, the five-star Renaissance, is lined with oil workers. At the in-house cafeteria of a modern apartment block used by the major contractors to house their staff, the sign-in book is a checklist of major contractors.

Atyrau is dominated by Kashagan and Tengiz Chevroil. Smaller operations also exist however – including one-person drilling outfits carried on under contract to the state oil company, KazMunaiGas (KMG), which provide the customer base for a number of existing Kazakhstani suppliers that operate exclusively in the domestic marketplace

KMG has a minority stake in practically all major projects in the country, and has a controlling stake in most projects initiated since 2000. Some 25 companies are controlled directly by KMG and roughly 60-70% Kazakhstani suppliers and contractors in the oil & gas industry operate under KMG's indirect patronage.[19]

The notion of a 'local' company was applied loosely, for purposes of field-based research for this report. For example, one of the contractors we spoke to was the expatriate owner of a 100% Kazakhstani company employing roughly 60 staff. Indeed, in conversations with business people and regulators, there seemed to be no clear distinction between 'local' (Atyrau oblast-based) companies and 'local' (national) companies.

There is no nationally agreed definition of what constitutes a 'local' company or 'local content' – operators are for the time being largely free to develop their own definitions so long as they comply with the terms of their production sharing or subsoil use agreements (the contracts on which exploration and production is based).

However, one expatriate former oil and gas sector executive remarked informally that one of the challenges for international operators is to address a sense at the very local level that 'local content' should in practice mean at the very least 'oblast-based', if not even more local than that.

One non-Kazakhstani smaller contractor explained that one of the problems in maximising genuinely 'local' employment from a company perspective lies with the perception that local people from Atyrau expect to be paid the same rate as workers from elsewhere, but are less productive.

National oil company KazMunaiGas is not only a significant player in the oil and gas sector in its own right, but also a significant client for local and national suppliers. We met with a number of Kazakhstani companies whose principal exposure to international standards comes through contracting relationships with various parts of the KazMunaiGas family. In this sense, efforts to stimulate good practice improvements within the supply chain of KMG can help to ready Kazakhstani suppliers for wider international contracts. Furthermore, KMG is increasingly positioning itself as at the very least a major regional oil company, gradually expanding its networks and acquisitions.

4. Stakeholder perspectives on oil and gas in Kazakhstan

There cannot be a citizen in Kazakhstan who is not aware of the role of the oil and gas sector in fuelling the country's economic growth and future prosperity. But perspectives on the pluses and minuses of the oil and gas sector are mixed. Some people believe that Kazakhstan sold her resources too cheaply to foreigners who are now taking wealth out of the country without bringing sufficient benefits. Others are

[19] http://www.kmg.kz/index.cfm?tid=28 Interviews with contractors in Atyrau in June 2007.

proud that Kazakhstan's natural resources have fuelled the country's economic boom. Almost everyone in the country believes that corruption accompanies oil – many people seem simply resigned to this as part and parcel of the country's overall operating environment.

At local levels in oil-producing regions, views perspectives vary depending on the community in question. Atyrau oblast, where Kazakhstan's oil capital is located, is amongst the poorest in the country despite being responsible for generating much of the country's wealth. There is anger among some opposition supporters that too little oil wealth accrues to the regions where it is generated, and that foreign oil companies effectively support authoritarian government practices.

In Berezovka village, on the outskirts of the sanitary protection zone established for the Karachaganak operation, many villagers believe that negative health effects and crop damage are due to oil and gas and want to be moved. Informal conversations suggest that stakeholders with an interest in the Berezovka case make little distinction in terms of local level impacts between the operator, its constituent joint venture partners, or its contractors – it is all 'Karachaganak'.

Environmental issues also figured in informal conversations with people in Atyrau, with speculation on the possible causes of Caspian seal deaths and the likely impact of sulphur storage linked to the development of the Tengiz field. According to officials in the Atyrau regional Akimat, the most immediate environmental issues from the major oil extraction activities in Atyrau are:

- Open storage and utilization of sulphur
- Water and fishing resources contamination
- Exceeding quota limits for emissions and hazardous substances by the operators

Few issues have excited so much national attention from Kazakhstan's oil-producing regions, however, as riots triggered in 2006 by perceptions of differential treatment of Kazakhstani and Turkish workers by contractors at the TCO plant and highlighted further in Box 1 below.

Box 1 TENGIZ RIOTS

On 20-21 October 2006 rioting on Tengiz oilfield erupted beween Kazakh and Turkish workers, involving more than 400 people and triggering large-scale departure of the Turkish workers from Kazakhstan. Construction of the Tengiz "second generation plant" in the Zhylyoi rayon/district slowed down as a result of the riots and got back on schedule only few months later.

An investigation by the Atyrau prosecutor's office and a special commission from Kazakhstan's Mazhilis (i.e. parliament) pointed to a number of underlying causes of the riots, among them unequal remuneration for local and foreign workers, disparaging treatment toward Kazakh workers by Turkish managers, overall poor working conditions and low living standards for local workers. Mazhilis working group findings also suggested the root of the problem lay in insufficient oversight over foreign companies' activities, and the fact that TCO general contractors are mostly of foreign rather than Kazakhstani extraction.

The company Senimdi Kurylys (SK) —where the riots took place—was established in 2000 by Bechtel International (50%) and Turkish-based Enka Inshaat (50%). SK is the subcontractor of Parsons Fluor Daniels (PFD) in the construction of a second generation plant for TCO.

Investigations after the riots also uncovered practices at TCO that involve 'blacklisting' of workers breaking certain regulations under TCO's "code 400", which makes them unemployable by TCO and its contractors. In 2007 the Zhylyoi district prosecutor's office was able to prove the existence of such code based on formal complaints from workers, deeming this practice anti-constitutional and in breach of Kazakhstan's Labor Law.

Sources: http://www.regnum.ru/news/736578.html; http://www.eurasianet.com 24/11/06; http://www.liter.kz/print.php?lan=russian&id=151&pub=5247 Megapolis Oct 23, 2006, Oct. 30, 2006

Subcontractors' practices have also been linked in press reports to current controversy over delays in the Kashagan contract with criminal investigations into alleged tax evasion by contractors to the ENI group.[20]

5. Regulation of the oil and gas sector in Kazakhstan: Roles, responsibilities and key policy frameworks

A. National policy and institutional processes

1) National Government

President Nursultan Nazarbayev appoints prime-minister, ministers, Akims—governors of territorial units/regions, signs state/international agreements. While the President makes final decisions on major strategic issues in the oil & gas industry, his administration examines, prepares and prioritizes presidential orders, adoption of laws, and supervises activities of state authorities and national companies—such as KMG and others.

The national government organ responsible for subsoil use is the Ministry of Energy and Mineral Resources. Other key Ministries include the Ministry of Finance (responsible for taxation policy), the Ministry of Labour and Social Protection (responsible for addressing poverty reduction and labour rights), and the Ministry of Environmental protection. The latter, which has been very active recently in the critique of the foreign oil companies environmental compliance, is responsible for the state policy on environmental protection and environmental management. The State Committee on Environmental Control is a special government agency responsible for compliance verification with all the requirement for environmental protection, as well as penalties and action measures. All of the aforementioned ministries and agencies are supervised by the Prime-Minister's office.

In his 2007 annual speech, the President specifically highlighted the need to pay particular attention to environmental compliance and overall performance of the investors in oil and gas, thereby encouraging and supporting critical stance of the MEP and CEC towards foreign investors[21].

Kazakhstan's Strategy of Innovative Industrial Development for 2003-2015 aims to ensure "*sustainable development of the economy through its diversification, establishment of new competitive industrial sectors, modernization and expansion of*

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[20] *Kazakhstan Halts Work at Kashagan oil field* Financial Times, August 27 2007, available online at http://www.msnbc.msn.com/id/20459193/, visited 31st August 2007

[21] http://www.akorda.kz

the existing infrastructure in order to move from an extraction-based industry to a service and technology-based economy"[22]

A range of bodies are tasked with management of oil revenues and economic diversification. Kazakhstan has an extractive industry revenue fund – the National Oil Fund of the Republic of Kazakhstan, which was established in 2001 and tasked with saving for future generations and provision of finance for the development of non-oil sectors.[23] Other bodies charged with aspects of economic management include the Kazakhstan Development Bank, National Innovation Fund, Investment Fund, and the Center for Marketing and Analytical Research et al. In 2006, these entities were grouped under the overall holding of Kazyna — a state umbrella fund for sustainable growth—which merged in 2008 with the state holding Samruk and is now SamrukKazyna Fund.

Exploitation of oil and gas reserves is governed by a legal framework which includes the Subsurface and Subsurface Use Law, Petroleum Law, Tax Code and Production Sharing Agreement Law. Many of these legal frameworks have been substantially amended since their introduction.

Environmental legislation was significantly modified in 2007 through the introduction of a new Environmental Code. However, further work is needed to develop detailed implementation mechanisms. For instance, while there are many prescriptive and aspirational messages around better standards, lower emission targets and better environmental management, methodologies and specific targets are underspecified.

In 2008, the government proposed a comprehensive new Law on Subsurface and Subsurface Use. Once adopted the Law would replace the existing Petroleum Law, Subsurface and Subsurface Use Law, and the Production Sharing Agreement Law. The changes proposed by the proposed draft Law have wide-reaching implications for the sector as a whole, including for the use of Production Sharing Agreements (which are no longer listed as among the permitted forms of subsoil use agreement) and corporate social investment (which acquires greater significance in the list of considerations for the award of subsoil use agreements so far as it relates to social development payments to local budgets).

Other framework policy documents also address the oil and gas sector: the Government of Kazakhstan Plan for Caspian Sea sector of 2003, and the Government of Kazakhstan Development Plan for the Petrochemical Industry of Kazakhstan for 2004-2010, adopted in early 2004. The first of these documents outlines primary tasks in the development of the Caspian, among them creation of domestic industries and scientific base, and the advancement of human development and technical training—all part of the drive to increase local content and make Kazakhstan's businesses more competitive internationally.

The extractive industries received intensive policy attention from the Ministry of Environmental Protection over the period 2006-07. Both the 2007 Environmental Code and a Concept on Sustainable Development adopted in 2006[24] make explicit statements on the need to strengthen oversight and environmental monitoring of oil

[22] http://www.government.kz/
[23] See generally, Norio Usui, *How Effective are Oil Funds? Managing Resource Windfalls in Azerbaijan and Kazakhstan*, ADB ERD Policy Brief Series No 50, December 2007, available online at http://www.adb.org/Documents/EDRC/Policy_Briefs/PB050.pdf
[24] Concept of Transition of the Republic of Kazakhstan to Sustainable Development for the period 2007-2024

and gas operators and investors' activities. So far as contractors and sub-contractors are concerned, however, environmental compliance monitoring by state agencies does not appear from our interviews to have been prioritised at operational level.

Local Content Considerations

Promotion of 'local content' in the oil and gas sector is a major government policy priority. The Ministry of Industry and Trade has attempted to formalize and unify the definition of 'local content' for all investors and to compile a comprehensive registry of local companies providing specialized services in different regions in the form of "The Unified Register of Domestics Producers and Foreign Investors". However, for the time being operators differ in their approaches to assessing local content, relying on various sources including production sharing agreements, the general definitions contained in existing laws, and international practice. A specialised agency, KazContract, oversees implementation of the government's overall policy on local content and collects statistics.

The 1996 Law on Subsurface and Subsurface Use (as amended) requires applicants in tender proposals to set out their proposed obligations to engage a certain percentage of goods, work and services of Kazakhstan origin meeting national and/or international standards, and procured on a tender basis, in the total value of goods works and services required. Broadly parallel provisions on engagement of Kazakhstan personnel are also incorporated within the Law. Definitions are given of 'Kazakhstan manufacturer', 'Kazakhstan origin' and 'Kazakhstan content', but these are too general definitively to resolve the issue of what constitutes 'local' content.

The 2005 Law Concerning Production Sharing Agreements (Contracts) when Conducting Offshore Petroleum Operations required for the first time that all new production sharing agreements include at least a fifty percent stake to be held by the national oil company KMG. The Law also contains specific requirements addressing local purchase of goods and services applicable to offshore exploration and production, providing that tender conditions shall provide for Kazakhstan content during the performance of offshore work.

The 1995 Petroleum Law (as amended) states that contractors have the right to engage subcontractors, but provides that these must be largely organisations of the Republic of Kazakhstan.

Detailed rules on tendering procedures are contained in Rules for procurement of goods, works and services when carrying out subsurface operations, adopted in June 2007 (in turn replacing earlier 2002 Rules) and amended in November 2007. These Rules address all subsurface operations, and apply to subsurface users and their subcontractors purchasing goods, works or services for carrying out subsurface operations (save that they do not apply in circumstances where separate law on Public Procurement, highlighted below, are applicable).

The Rules specify methods by which procurement must be undertaken, reserving single-source tenders for defined, limited, circumstances. Particularly relevant in light of barriers highlighted by Kazakhstani contractors interviewed in the course of our research, information on tenders must be published both in Kazakh and Russian, at least 30 days prior to the date set for submission of bids in national periodicals and on the web site of the authorised body. Detailed procedures for the tender process are specified, and the Rules contain a 'positive discrimination' in favour of Kazakhstani contractors: they provide that comparing bids for the purpose of selecting the winner of a tender an organizer must decrease the price bid by a Kazakhstan provider by 20%.[25]

It was not possible to evaluate the effectiveness of these Rules during the course of our research: in practice, many of the barriers cited by interviewees may have well have been in breach of Rules applicable at the time when the events complained of took place. Furthermore, we can anticipate that these Rules will be revised and amended in the near future in order to address feedback from the industry and other government agencies.

Changes proposed in the 2008 draft Law on Subsurface and Subsurface Use build on this overall legislative history. Subsoil contracts are to be based on a model contract appended to the draft Law. Mandatory contract terms are to include provisions on % of Kazakhstan personnel and allocations of Kazakhstan goods, works and services. In a new development, the draft provides for provision of equal conditions and remuneration for Kazakhstan personnel *including those engaged in subcontract work*. Provision in contracts is also to be made for fines for failure to meet local content requirements.[26]

Further support for creation of a level playing field for Kazakhstani contractors is provided by public procurement legislation (in the form of the 2007 Public Procurement Law) which requires a public tender for supply to state agencies (or state-controlled companies) of certain goods, works and services. Amendments introduced in November 2008 introduce electronic procurement and, additionally, aim further to strengthen the position of local providers of goods and services. Preference is to be given to local manufacturers where "the quotations presented are equal". Furthermore, the Law begins to address the wider definitional challenge of what constitutes 'local' content: a "domestic provider of work and services" is a Kazakhstan resident individual or a legal entity whose workforce is no less than 95% local. For a "domestic entrepreneur" to be recognized as such he needs to be a resident of Kazakhstan doing business in the country.[27]

Varying approaches to defining and reporting on local content can lead to difficulties in the interpretation of statistics provided by operators. For instance, in statistics provided to the Atyrau Akimat, TCO reported 17% increase of local content value in 2006 in comparison with 2005, and KCO reported 32% decrease for the same comparison. However, overall, it is difficult to compare such figures with others produced by different agencies, since their determination is based on different methodologies. In the case of information provided to the Atyrau Akimat, the 'local' of 'local content' seemingly refers to the proportion of local Atyrau companies and suppliers, not 'nationally local' Kazakhstani companies.
In the course of 2006-07, we have seen establishment of 'local content departments' in many companies and increasing interest from the government to this topic with the

[25] Source: Joel Benjamin, Marla Valdez, powerpoint presentation, KIOGE 2008 Pre-conference workshop, 7th October 2008, available online via http://www.kioge.com/ftpsite/index.php?&direction=0&order=&directory=Presentations%20KIOGE%202008/Pre-conference%20Workshop%20-%207th%20Oct

[26] Source: Marla Valdez, powerpoint presentation, KIOGE 2008 Pre-conference workshop, 7th October 2008, available online via http://www.kioge.com/ftpsite/index.php?&direction=0&order=&directory=Presentations%20KIOGE%202008/Pre-conference%20Workshop%20-%207th%20Oct

[27] Information based on McGuire Woods legal bulletin: *Amendments Made to the Public Procurement Law of the Republic of Kazakhstan*, 15th November 2008, available online at http://www.mcguirewoods.com/news-resources/item.asp?item=3724, last visited 15th March 2009.

Kazakhstan Contract Agency under the Ministry of Industry and Trade specifically tasked to address these issues. As a result of all this activity in the short term, we can anticipate move toward a more consistent approach in local content calculation, further development of the comprehensive and accessible Registry of local and national contractors, and strengthened coordination in this area.

B. Regional government roles

Regional Akims/Governors and Akimats hold considerable power in the regional context, being the main channel of state presence and management in the regions. The Akimats are responsible for the overall development of the regions, maintaining and applying national laws in the regional context, responsible for the regional budget planning, distribution and spending.

Notionally, the powers of regional Oblasts (the main unit of ‘higher level’ regional government) are limited in relation to oil and gas projects. But the Oblasts typically oversee implementation of companies’ mandatory social investment contributions in a variety of ways – and oil companies work to maintain good relations with the political and administrative leadership of Oblasts.

Within Atyrau Oblast, special committees or councils on environment, social infrastructure and investments, business development were established by the Akimat in order to deal with these issues in a wider representative circle as well as increase the influence of the Oblast in areas where they do not formally exercise responsiblities. Such councils, usually under the leadership of Akim or Deputy Akim, have provided effective channels for discussions between the investors and local government.

Whilst formally, regional Akimat’s powers are limited as far as interference in the oil and gas industry is concerned, there are different ways how regional Akimat is featured in the local oil and gas developments. At the very local level, the city Akimatis tasked primarily with addressing the city municipal needs, in this case city of Atyrau, and most oil operations fall out of its jurisdiction.

In some cases, regional Akimats may become full or partial beneficiaries for oil and gas companies’ social investment contributions under production sharing agreements. In that capacity, Akimats may for practical purposes be in charge of social investment spending, prioritizing and developing its own social projects and investments, with varying degrees of input from operators, even when contractors and sub-contractors deliver the projects. NGOs and community members perceive the outcome and targets for social investments to be a reflection of political machinations on the government side and lacking in oversight or collaboration on the operator’s side

Because the regional Akimat is tasked with strategic distribution of budgetary spending among various *rayons* (i.e. ‘Oblast’ sub-divisions), the social deductions from foreign operators do not necessarily end up being spent in areas adjacent to exploration zones.

In our interviews, quite a few people from local government agencies and Akimat have commented that their relations with the public relations representatives of major oil operators—Chevron and Agip/KCO—are mostly amicable as long as the former do not probe too deeply into the operations or ask controversial questions.

As to environmental compliance, technically the Akimat cannot directly monitor or intervene, but it can request necessary documents from the regional committee on environmental control (an agency which operates separately from Akimat and reports to the National Committee on Environmental Control).

As a matter of regular practice, companies/operators do submit on a voluntary basis, at the Akimat's request, parts of the monitoring reports that they provide to KazMunaiGaz and the Ministry of Energy and Mineral Resources. Normally, companies want to maintain their good standing with Akimat and meet them halfway in the requests for additional contributions or charity for various regional needs.

Quite a few observers from non-governmental organisations in Atyrau commented that it is precisely those give-and-take relations that make the whole system impenetrable for outsiders. Moreover, additional insulation for project operators and their partners is provided by restrictions on information disclosure incorporated within the text of production sharing agreements.

Akimats are also tasked with business development and promotion, and as such they contribute to the activities of oil and gas industry local content programmes. For example, in Atyrau the Akimat participates in the development of local oil contractors programmes in collaboration with the Small and Medium Enterprises Fund (itself under Kazyna) and investors. Local companies are often invited for training sessions where issues relating to vendor qualification requirements from the operator side, certification requirements and overall business development opprtunities are discussed and addressed.

In Atyrau, the Akimat's recent efforts have been noticed by some local contractors who indicate overall usefulness of such training. At the same time, one view from a local contractor emphasises that business opportunities are realised only by select favourites that are pushed by the Akimat onto operating companies' vendors (i.e. suppliers) lists.

C. Production sharing agreements and subsoil use agreements

Production sharing agreements and subsoil use agreements, as well as applicable policy and legislation described above, have a major impact, directly or indirectly, on relationships between operators, their joint venture or consortium partners, and contractors. For example, they may contain nationalisation targets or provisions requiring preference to be given to Kazakhstanis in cases where they have at least equal knowledge, qualifications and experience. Production sharing agreements and subsoil use agreements also typically contain local content requirements and targets. The detailed terms of supply chain contracts are also in part determined by the obligations of consortium partners within the investment agreements under which they operate.

Neither production sharing agreements nor subsoil use agreements define the entirety of the management systems approaches that are applied to manage supply chain issues, nor the norms that are found within contracts. But they have an impact on what is included, and provide a baseline normative basis for contracting relationships.

Indeed, production sharing agreements and subsoil use agreements may themselves contain explicit requirements that subcontractors be required to comply with the terms of these agreements – for example in the form of a requirement that the "*Contractor shall require each of its subcontractors to comply with the terms of this agreement in each contract with each subcontractor…*"

Beyond these general observations, it is hard to be more precise about the implications of oil and gas contracts for environmental and social performance in the oil and gas supply chain. The terms of contracts between operators and their subcontractors are not publicly available. And in Kazakhstan (though not universally), the terms of oil and gas investment agreements between investors and the government of Kazakhstan are considered confidential in their entirety. At least some agreements include provisions expressly prohibiting disclosure of the terms of individual Production Sharing Agreements. Even regional authorities do not as a matter of course have access to the full text of the agreements, even in circumstances when they may have directly relevant regulatory and enforcement responsibilities.

What is clear is that production sharing agreements and subsoil use agreements for significant projects will incorporate a mixture of national legislation and oil industry good practice standards. As to international standards, for example, oil industry guidelines such as the Oil industry international exploration and production forum guidelines on health, safety and environmental management; the International association of drilling contractors safety and environmental guidelines; the International Association of Geophysical Contractors (IACC) safety and environmental guidelines or the American Conference of Governmental Industrial Hygienists Threshold limit values for chemical substances in the work environment may be explicitly incorporated in the contract – to the extent that they do not conflict with relevant provisions of Kazakhstan's national legal framework.

Production sharing agreements and subsoil use agreements may also effectively make contractually binding the environmental and health and safety management system adopted by the oil and gas operators – for example one major production sharing contract requires that petroleum operations be conducted "in strict compliance with all applicable EHS laws of the republic, principles and procedures in the internal EHS management system."

In these circumstances, it becomes relevant to examine how much flexibility is in practice allowed by operators for major (or local) contractors to adopt broadly equivalent management systems and norms. In Atyrau, where there are just two major operators, it ought to be easier to bring the two sets of standards together– though differences remain. In practice, negotiations with major contractors are lengthy processes and are likely to involve a process of examining the equivalence of operator and major contractor standards. In turn, major contractors apply detailed due diligence procedures in respect of their own subcontractors and pass their standards down the chain.

D. Other relevant initiatives

Other initiatives in Kazakhstan which have the potential to offer levers for change in the practices of suppliers in the oil and gas supply chain include the Extractive Industries Transparency Initiative (EITI), launched in 2002. The initiative exists to provide a platform for host country governments, extractive sector businesses, and non-governmental organisations to negotiate mechanisms for voluntary. International support is provided from a variety of donor agencies, the World Bank, and a small Secretariat based in Oslo. However, the initiative focuses principally on the operators of oil and gas and mining projects and their joint venture partners – not contractors further up the value chain.

In some respects, however, Kazakhstan is a global leader within the Extractive Industries Transparency Initiative, with the adoption in January 2007 of rules requiring applicants for new subsoil use rights to participate in the initiative – the first government to make EITI participation mandatory.[28]

It is at least possible that for the future, Kazakhstan's participation in the EITI may provide a trigger for greater transparency over some topical aspects of contractor behaviour. For example, in August 2007, Kazakhstan's Finance Ministry announced that it would be launching a criminal investigation into "alleged customs tax evasion by subcontractors working for the ENI group". The Ministry is reported in the Financial Times to have said in a statement that "Preliminary losses to the Kazakh budget resulting from the unlawful actions by affiliates of the consortium amount to over $2.5 million".

6. Integrating quality, environment, health and safety and social and local content considerations in the supply chain

A. Health and safety

Most Kazakhstani companies with whom we spoke are aware of the need to maintain high standards of health and safety if they wish to be included in the supply chains of the major international projects. In our conversations, driving and road safety were the most frequently cited unprompted examples of efforts to improve health and safety awareness and performance. Anecdotally it appeared that health and safety requirements were generally taken seriously by senior management. Many Kazakhstani suppliers, similarly, showed awareness of, or commitment to, attaining recognition for quality management systems through certification to the ISO 9000 total quality management standard.

However, as against these positive insights, it appears from our interviews that environmental performance and its management lies behind health and safety as a priority for both operators and their contractors.

B. Managing and certifying quality

It proved difficult to gather information on supply chain processes. Kazakhstani contractors showed awareness of the ISO 9000 total quality management approach with quite a few contractors already certified, as it is increasingly being required by the government and promoted at the Akimat's level. Business trainings were sponsored by the Atyrau Akimat in order to encourage local contractors and suppliers to go for ISO 9000. However, some of the local contractors indicate that for this certification to work, it needs to be integrated into business practice not only on paper but in realilty.

One specific comment was: 'certification in itself is not an issue—I could produce it for you tomorrow. But if I want it to work in my company for real, it does require a lot of time, resources and effort—which is a luxury I cannot afford at the moment—and we are planning for it in the near future, because business partners demand it'. Likewise, because it is such a resource-consuming process, it was indicated that larger companies can better afford it while smaller ones can implement it faster.

From our discussions, it appears that there are currently no indigenous Kazakhstani audit and certification companies within the country who provide services to the oil and gas sector. So accreditation, verification, certification and ongoing auditing (where this is contracted out), all basic performance management functions, are carried out by the international majors – SGS, Bureau Veritas and Moody – all of whom operate in Kazakhstan. At the time of our research, there did not yet appear to

[28] Macleod Dixon Kazakhstan Legal Bulletin, 30 January 2007

be any domestic company providing accreditation, verification, certification and ongoing auditing services linked to the requirements of major oil and gas operators.

ISO 9000, however, has been a focus of indigenous capacity-development; albeit donor-triggered. A donor-funded USAID initiative has provided support for the establishment (by the Kazakhstan branch of US consultancy Pragma) of an NGO – the Quality Management Centre (QMC) – whose role is to provide training and pre-audit ISO 9000 services for enterprises throughout Kazakhstan. There is a range of other organisations (both local and international) providing ISO 9000 training to the Kazakhstan market.[29]

C. Local content

As indicated, in general, local content issues appear to be much higher up the oil and gas agenda than environmental and social standards. As one would expect given the Government of Kazakhstan's emphasis on local content, this area is perhaps the greatest priority for the major operators – and among the major concerns both of Kazakhstan's citizens and oil sector suppliers. Most Kazakhstani and international contractors are aware of the business and policy imperative to enhance local content. In the context of Kazakhstan, this may itself be described as an aspect of social performance.

The major operators all have programmes of one kind or another to enhance local content. For example, Agip-KCO notes that the main objectives of its Local Content Development programme are:

- *to maximize the presence of local companies in Agip KCO's operations;*
- *to increase local companies awareness of Agip KCO and its major sub-contractors' contracting policies, standards and expectations;*
- *to provide an assistance in vendor qualification process and preparation to tender;*
- *to facilitate creation of partnership with international companies;*
- *to promote the role of Agip KCO as active supporter of communication between local and international companies;*
- *to support Agip KCO's main contractors in better understanding of local companies' industrial and business capabilities, finding suitable local subcontractors and sources for supply of material, equipment and services.*[30]

A representative of one major operator working on local content issues remarked that over the past six or seven years Kazakhstani companies' skills had 'really increased', to the extent that the real issues today are less about basic capacity problems and much more about relationship management. Three local contractors commented that they met better qualified locally hired professionals than expats working on the operator's behalf. These comments tended to address KCO rather than TCO.

Chevron provides Operational Excellence System trainings and makes efforts to assist local contractors when they experience difficulties meeting operator standards. In fact, two local contractors praised TCO for such efforts, although they pointed out most training sessions were on safety and technical requirements with hardly a mention of environmental and none of the social requirements.

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[29] Adapted from http://www.pragmacorp.com/edp.htm
[30] http://www.agipkco.com/en/vendor_support/vendor_support_en.htm

D. Nationalisation

Nationalisation – the process of increasing the proportion of Kazakhstani's within overall workforces - remains a challenge. An expat with long experience working in Kazakhstan remarked during an informal conversation:

> *"Nationalisation should be about training a national alongside an ex-pat and then after a period of training the expat loses their job. But here, it's not really done as nationalisation. Because here, nationals get hired, but expats don't lose their jobs once the nationals have been trained – they just get shifted around. And the PSA requirements on nationalisation are simply targets – they don't say anything about the nationalisation process itself".* (Quote approximate)

A senior manager from a major operator indicated that reaching the nationalisation target at the lower management level has been achieved, while progress hiring middle and upper-management nationals has been slow and uneven. Issues relating to lack of equality between Kazakhstani and non-Kazakhstani staff in relation to salaries, benefits, rate of promotion and other perks remain contentious.[31]

7. Barriers to entry for contractors

Contractors – both local and foreign – cited many barriers to entry in the supply chains of the major international operations. Chief among these was uncertainty over requirements within the qualification process of the major contractors and the time taken to qualify – as much as eighteen months to two years, with perhaps four months for the prequalification process alone.

For smaller companies, the costs involved in embarking on the uncertain prequalification process, in terms of manpower and time alone, may simply be prohibitive. A 2005 World Bank report (*Getting Competitive, Staying Competitive: The Challenge of Managing Kazakhstan's Oil Boom*) suggests that forming ties with global suppliers is one way in which firms can themselves become global suppliers – citing Turkish firm Enka's (ultimately controversial) alliance with Bechtel to supply the TCO project.

But the report goes on to suggest that 'the best option for local companies is usually to become a supplier to a supplier, not directly to an oil company'. Operators themselves tend to know relatively little about what is happening at the higher levels of the supply chain beyond their major tier one contractors.

Other strategies mentioned during our conversations in Atyrau included groups of smaller Kazakhstani companies getting together as a consortium, under one lead company, to present a stronger profile to major oil and gas companies. Foreign contractors may themselves develop Kazakhstani 'spin-off' companies over time, supported by local patronage.

One contractor, Senimdi Kurylys, created out of the Bechtel-Enka partnership, was cited as having spun off two companies, supported NefteStroyService and lending equipment and 'showing [their partners] how to do things'.

[31] Addressed in the 2008 Draft Subsoil and Subsoil Use law, which provides for equal conditions and remuneration for Kazakhstan personnel – including subcontractors.

Box 2 Overview of obstacles to domestic supply into the oil and gas sector

Dominance of global over local supply chains – with international oil companies preferring to deal with their global suppliers

Difficulty identifying where to enter the value chain – with major contracts awarded to specialist firms such as Schlumberger or Halliburton, it may be better for local companies to become suppliers to these 'tier one' contractors rather than directly to operators themselves.

Information gaps – since it is often difficult for oil companies to identify and assess the suitability of Kazakhstani suppliers, as they may have very short track records or little equity to support their bids. At the same time, it can be difficult for Kazakhstani suppliers to now about opportunities to supply goods and services

Standards – since oil companies are often hesitant to source from a local firm that has not been granted international certification, such as ISO, API or ASME, regardless of the quality of the firm's work

Safety and environmental concerns – specifically that local firms need to be able to accommodate international oil company and KazMunaiGas concerns about safety and working practices, including environmental working practices

Source: *Getting Competitive, Staying Competitive: The Challenge of Managing Kazakhstan's Oil Boom*, The World Bank Group, 2005

In our conversations, contractors generally took care to distinguish between the two major Atyrau-based operators, Agip-ENI and Chevron. In brief, overall comments were that TCO seemed better organised and that whilst their qualification requirements might take a lot of effort to meet, they were clearer from the outset than those of Agip-ENI. That this should be the case was perhaps surprising, in view of the significantly greater amount of information publicly available about the KCO approach than the TCO approach from web-based sources.

For example, one smaller contractor remarked that they had spent

> *"about four months in the prequalification stage - for example, they [Agip-ENI] want copies of certificates to prove that people have passed the exams they have, they want to check plant and machinery. And it can be expensive – for example, a marine inspection we had to get done cost USD 20,000. Agip-ENI apply Kazakhstani standards, international standards – no-one's sure what the rules are. TCO is much more organised. You know what their standards are. And Agip are tied into Italian contractors, even when local options available. People who work at Agip-ENI don't care – they're 4 weeks on and 4 weeks off. The project is running late – but people don't care. It's like they're old-fashioned civil servants".* (Quote approximate)

In another example, one contractor offered an example of a perceived tendency of operators to pass the implications of 'local content' requirements down the supply chain in circumstances where they themselves would be unwilling to take on risks that may be associated with them.

For example, in the context of a conversation on the implications of requalification processes for each major contract process (so that 'vendors' are required to requalify for each major contract) one foreign contractor commented that the qualification requirements may change. On the issue of insurance, he commented:

> "*We had to requalify for a tender. And the requirements had shifted – from having insurance in place, to having insurance with a Kazakhstani insurance provider. But it's a very new market in Kazakhstan. We have 1000 employees – why would we take on the risk of insuring through Kazakhstan's insurance market?*" (NB: quote approximate, designed to convey the flavour of the original comment).

One shortcoming of the current regulatory environment highlighted by contractors concerns the lack of convergence at times between the standards and regulations applied to and by international as distinct from local companies. For instance, when a local contractor has to comply on the one hand with the set of local/national standards from the government side, and on the other hand with all the standards required by the operator, there is a double burden on the local contractor in cases where the two sets of standards vary.

This is also a concern for major contractors. Rightly or wrongly, a representative of one major contractor felt that Kazakshtani regulators' lack of willingness to recognise the widest implications of ISO 9000 certification for purposes of domestic regulation was a meaningful barrier to operating. He highlighted difficulties in obtaining authorisation for using a particular chemical which was specifically addressed in this company's ISO 9000 certification and needed in fairly small amounts for a couple of months in one particular process. The ISO 9000 certification is not recognised for the purposes of Kazakshtani regulation of the chemical, which also has the potential to be used in the manufacture of certain drugs. After eight months and expenditure of perhaps $20-25000, the application for authorisation had still not been successful.

Language barriers to entry were also mentioned by one Kazakhstani supplier in Atyrau. This supplier complained that most tender documentation and associated communication materials are produced only in English – not in Russian, Kazakhstan's 'international lingua franca' and the language of interethnic communication in the country, let alone the Kazakh language. This invariably lengthens the time for the local company to prepare their documents, not to mention requires additional resources for professional technical translation services—creating additional threshold for entering the tender. Moreover, such practices generate some discouragement and even negativity—that some of the contractors have expressed feeling while engaging in communications with foreign operators on tender process.

Another interviewee commented that in the past, problems of Kazakhstani companies' access to tenders had also arisen because tenders were issued outside Kazakhstan, or in forums where Kazakhstani companies could not access them. Informally, another oil and gas sector worker remarked that much amusement had been caused by a presentation by Agip-ENI in Kazakhstan which had been delivered in Italian, with no interpretation.

Elsewhere, a legal expert remarked that since Agip-ENI had become technical operator of the Kashagan project, there had been much less emphasis on maximising the involvement of Kazakhstani enterprises in the oil and gas supply chain. Shell, some people have suggested in conversation had a much better approach to local content development. Indeed, Shell's global approach to local content development was also cited as a benchmark by one Kazakhstani public sector official.

These barriers represent very basic issues that, to the extent they still exist, are readily addressed – though not without cost to operators. Tender documents should clearly, as a matter of course, be produced in the language of the 'host country' as well as the language of the operator company (or English as the case may be). They should be posted on websites, or in other media, that are readily accessible to Kazakhstani contractors, such as Akimat websites, regional newspapers and the website of the national registry of local contractors in the oil and gas industry. Indeed, many of these requirements are now explicitly addressed in the 2007 amended Rules for procurement of goods, works and services when carrying out subsurface operations.

Two local contractors commented that they did not mind opening their books and making their accounting system more streamlined and even transparent. However, any suggestion to add specific reporting requirements on environmental and social indicators was seen as cumbersome and requiring additional resources and training. One of the contractors specifically remarked: '*if the operator or the government would explicitly demand and prioritize environmental and social standards compliance and create such specific demands, we would have to somehow pay attention to that and invest in our own capacities. As it stands, those considerations are not priorities and I don't forsee them becoming so in the near future…at least as far as our business relations are concerned*'. (Quote approximate)

8. Strategies to overcome constraints/enhance opportunities

A. Strategies for contractors/operators

More than one staff member within major international operators or joint venture partners considered that it could be very hard to press on established contract-holders for improvements once contracts had been concluded. A representative of a major contractor operating in Kazakhstan remarked, in a broadly complementary comment, that the realities of the commercial structure and profit margins under which contractors operate mean that it is difficult to take on additional issues – costs specifically – once contracts have been concluded. Margins are simply too tight. Much is likely to depend on the specific subsector at stake.

One clear area for further investigation concerns the strategies that can be deployed by major contractors and operators to incentivise good performance on the part of their contractors. The perception of operators that little can be done once contracts have been signed is a clear barrier that could usefully be addressed through dialogue involving project managers and lawyers. It should be possible to develop approaches for sharing costs of efforts to address reputational issues that arise after contracts have been signed, where these have potential to impact negatively on the reputations of operators.

If operators feel that their options, in terms of requiring or incentivising changes in contractor practices, are limited once long-term contracts are signed, one strategy is to reward good performance. A representative of one major operator remarked that one of the ways in which good contractor performance can be rewarded is through small incentives such as family-oriented 'prizes' or gifts – for example outdoor equipment such as camping stoves.

This said, one contractor remarked that when there were problems in Atyrau with Turkish workers (in the context of Turkish contractor Enka's work there), "*TCO didn't take responsibility – they said 'that's the contractors, not us. But the responsibility for managing impacts should lie with the operators – it's attributed to them. Legally of* *course the situation might be different, but in terms of perception it's their responsibility*". (Quote approximate)

Given the incidence of tensions between Kazakhstani and foreign workers in Atyrau, management tactics and approaches that can effectively manage and resolve conflict are of particular relevance. Informally, one former construction industry manager described the tactics he had successfully deployed to prevent breakout of tensions between Turkish and Kazakhstani workers within his former employer – including strict division of line management along national lines. Whether this precise experience is desirable or transferable or not, it points to the potential value of sharing management experiences both within the oil and gas sector and other sectors – particularly construction – operating on the back of Kazakhstan's oil boom.

B. Optimising the enabling environment

Education and training within Kazakhstan are critically important determinants of whether the oil and gas sector is able to access skilled local labour and enterprises. For many potential employers the availability of qualified people is the single greatest barrier to enhancing local content in the oil and gas supply chain. Other factors mentioned in interviews and questionnaires included quality of service; absence of standards; and presentation and networking skills.

This is an area where more could be done, and one that is considered the central barrier to progress by many in terms of building local supply chain capacity. Critically, it is also an area where both government and businesses have an important role to play – to the benefit both of major operators and their partners and the overall competitiveness of the country as a whole.

One expatriate oil and gas worker remarked that the University of Atyrau (Dosmukhambetov University) – effectively the major tertiary education institute in the country's oil capital – does not have capacity to deliver a locally qualified workforce. Its technical capacity on oil and gas is considered weak. Standards at the Kazakhstan Institute of Oil and Gas under KMG are also considered low by at least some oil and gas sector employers.

Anecdotally, it appears that much of the external (as distinct from in-company) education and training budget of the major oil and gas companies is spent with institutes elsewhere in the country, including in particular (but not only) the Kazakh-British Technical University in Almaty. Many major foreign oil and gas companies in Kazakhstan contribute to the work of this institute under the patronage of Dinara Kulibayeva, President Nazarbayev's middle daughter.

9. Corruption

Corruption remains a systemic problem in Kazakhstan's oil and gas sector – eradicating it is a central challenge in building the 'enabling environment' for Kazakhstani companies to enter oil and gas supply chains. Anecdotes abound. 'Everyone wants their piece' complained one supplier. It seems likely that at the 'lower' less visible end of the chain, it is common practice for local contractors to pay their way into the supply chain in a variety of ways.

Aside from skewing the smooth functioning of markets, bribes and facilitation payments have a number of adverse consequences from a social and environmental performance perspective. Corruption and bribes payable in the acquisition of scarce work permits for foreign workers can mean that those international workers who do come are less qualified than the international norm – even so far as to prompt the comment that some expat or foreign workers benefiting from scarce work permits ‘wouldn’t be able to get a job anywhere else in the international industry; they are too low-qualified’.

For the major operators, transactions carried out in the ‘lower’ parts of the chain may remain invisible to all intents and purposes, despite their potential to create reputational risks higher up the chain. Lack of resources for auditing supply chains may be one problem. But more than once we encountered a sense among staff working within the major operators that their power to change the way in which things are currently done is limited, even as contractors feel that operators call the shots.

At least one major contractor, Baker Hughes, has been prosecuted for corruption offences under the US Foreign Corrupt Practices Act (highlighted in Box 3 below)

Box 3 Litigating Corruption: Baker Hughes Services International in Kazakhstan

In April 2007, the US Securities and Exchange Commission (SEC) filed a ‘settled action’ against Baker Hughes Incorporated, a major contractor providing oil products and equipment worldwide. The SEC’s civil charges were laid in connection with allegations of major bribery and kickback payments (involving some $5.2 mln). The US Foreign Corruption Practices Act is itself incorporated into Federal Securities Law, which enables the SEC to bring civil enforcement actions.

In one case an agent retained to influence officials of state-owned oil companies was allegedly paid a total of $4.1 mln in order to ensure securing contracts for provision of services to the Karachaganak consortium after a major tender process had closed. The approval of the state oil company, Kazakhoil, was sought by the consortium at various stages of the tender process for the award of a very substantial oil services drilling contract. After retaining the agent, Baker Hughes was awarded a significant oil services contract worth $219.9 mln in gross revenues over the period 2001-6. Of the total payments, $1.8million was paid by Baker Hughes on behalf of its subcontractors. The total payments represented a 2% commission on net revenues earned by Baker Hughes and its subcontractors on the Karachaganak project.

The SEC’s complaint provides rarely publicly available information about the way in which Baker Hughes’s internal bidding process was managed for the purposes of the single integrated bid for the contract. Baker Hughes’s subcontractors in this integrated bid were also implicated. As the SEC complaint explains:
“Because any agent commission payments would also have a financial impact on expected revenues to the subcontractors who were associated with Baker Hughes’ bid (because the commission payments would be deducted from the revenue due to the subcontractors), [a Baker Hughes official] also scrambled to get their approvals to the commission payments”… Later, in 2002, a Baker Hughes subcontractor was bidding on a series of unrelated Karachaganak contracts. The subcontractor was contacted by a Baker Hughes employee indicating that the agent was interested in representing the subcontractor in its bids on the same terms as Baker Hughes itself had been represented. Before discussions on agency were concluded, the subcontractor was awarded the contract, and after initially indicating that they would not be requiring agency assistance subsequently concluded a sales representation agreement in relation to the award of that contract.

In a second set of facts at stake in the SEC case, the SEC alleged that from 1998-1999 payments to an agent of nearly $1.1mln were made 'at the direction of a high-ranking executive of KazTransOil', reflecting a commission of approximately 30% on gross revenues in respect of award of a chemical contract of $3.2million. The SEC complaint went beyond Kazakhstan, also alleging violations of requirements for proper internal controls in Russia, Nigeria, Angola and Uzbekistan.

In parallel, the US Department of Justice filed criminal charges against Baker Hughes Incorporated and its Atyrau-based subsidiary Baker Hughes Services International on grounds of violating the Foreign Corrupt Practices Act in relation to activities in Kazakhstan.

In the SEC case, Baker Hughes agreed to disgorge a total of $23 million 'ill-gotten gains' including some $3 mln pre-judgment interest and $10 mln in civil penalties related to violation of a prior SEC so-called 'cease and desist' order, in any event without admitting or denying allegations in the complaint. In the criminal FCPA case, the company pleaded guilty and paid $11 mln in criminal fines, whilst agreeing to retain a monitor to review and assess the company's compliance and implementation program in accordance with new internal policies.

Sources: http://www.sec.gov/litigation/litreleases/2007/lr20094.htm
http://www.reuters.com/article/governmentFilingsNews/idUSN2728075120070827?pageNumber=2, both last visited 2nd November 2007

Understanding on appropriate responses to the problems of bribery and corruption needs to become more sophisticated. Management responses that simply remind workers of contractors' 'zero tolerance' for bribery and corruption are unlikely to remove underlying issues – which may be as much to do with the pressure of performance targets that are much more easily met if workers succumb to bribes or corrupt payments.

10 Summary and Conclusions

Oil and gas contractors are key actors in a number of the most significant environmental and social issues facing Kazakhstan's oil and gas sector – from management of sulphur from the Tengiz project, to US bribery charges involving major contractors and riots involving Turkish and Kazakhstani workers. Improving the social and environmental performance of contractors, then, has potential significantly to enhance the performance of the sector overall.

Kazakhstan's policy-makers have actively sought to address all of these issues, but significant challenges nonetheless remain. Among the most significant among these is the need to find workable ways to ensure that environmental issues are considered on a par with health and safety issues in terms of importance in the contracting relationship. For this to happen, skilled and more consistent environmental monitoring of contractors will be required from the government side, as well as clearer advance signalling on environmental issues from operators to their contractors.

On the industry side, we were struck by the sense of an impasse in which major contractors do not feel that they can adequately influence contractor practices, and contractors feel that they have much room for manoeuvre either. This mutual frustration indicates that there could be real value in creating spaces for dialogue involving operators, contractors and subcontractors, with a view to identifying obstacles to enhanced social and environmental performance on the part of contractors. For the future, our parallel work in Russia and the outcomes of a workshop held in London in December 2007 indicate that there might be real value in providing space for such dialogue across countries in the region – perhaps including Russia or other Caspian oil and gas-producing countries. Involving public policy actors in such conversations would help to ensure that insights could inform public policy, but there might equally be value in industry actors meeting together in the first instance to address commercial aspects of contracting relationships from environmental and social perspectives.

Maximising Kazakhstani 'local content' in the oil and gas contracting chain is a major priority among both citizens and government in Kazakhstan. It is also an area that has been the subject of wide-spread policy action at the national level. In principle, maximising use of skilled Kazakhstani contractors could also help to reduce operators' costs. Even so, our research identified a number of obstacles facing Kazakhstani contractors seeking to access international oil and gas contracting chains operating in Kazakhstan. Some of these (such as the language in which tenders are published - and how they are disseminated) are addressed by existing rules. Elsewhere, development of integrated policy approaches is to some extent hampered by the range of different legal and contractual approaches currently in place for defining 'local content' (and that are likely to remain in play for the foreseeable future). Whilst imprecise definitions can on occasion work to the benefit of operators, we suggest that nonetheless there be a push to arrive at common understanding – tailored to the realities of different projects' contracting requirements – of how best to draw dividing lines between 'Kazakhstani' and different levels of 'local' content.

More significantly, however, there appears to be significant scope for improvement in the development of a skills base that is capable of delivering Kazakhstani 'local content' and 'nationalisation' of workforces. Getting an optimal enabling environment for development of that skills base, making use of the combined skills and competences of public and private sector actors needs to be a major priority. Legislative adoption of a principle of equality as between Kazakhstani and non-Kazakhstani workers in the contracting chain will help to address some of the underlying sources of tension around benefit-sharing from Kazakhstan's oil and gas sector. However, taking this principle seriously will likely call for greater investment in knowledge transfer and capacity-building to ensure an optimal skills base.

Our limited research indicates, for example, that investment in tertiary education that could deliver an appropriately skilled Kazakhstani workforce has been patchy. In particular, the lack of world-class tertiary education for the oil and gas sector in Atyrau itself stands out. For the future, the creation of a structured Commission or standing Round Table on Oil and Gas Sector Skills, involving representatives of relevant Ministries and agencies and Akimats, as well as the industry itself, could help to deliver coordinated initiatives and partnerships that harness the skills currently available within the country whilst working to deliver a globally competitive skilled workforce and enterprise base for Kazakhstan's oil and gas sector. Such an initiative could also help existing operators more efficiently to meet their contractual commitments relating to local content and nationalisation.

Finally, a word on access to information. This is not an area in which a great deal of information is publicly available. Even key policy actors, such as Akimats, do not have ready access to information in some areas – such as the terms of operator's contracts – even when they carry some implementation oversight responsibilities. Little information is available about the detail of contracting practices, and operators are wary of providing information to third parties that would ordinarily only be available to proposed contractors. Insights from our research to date therefore need to be treated with care. To some extent this might not be a problem so long as the information is available on a ‘need to know’ basis within the sector itself. Nonetheless, we consider that the importance of the oil and gas sector as a whole to Kazakhstan’s economy and to citizens’ own perceptions of their country mean that there would be real value in finding ways for public sector actors and the industry to make available more detailed information about environmental and social requirements and performance in the contracting chain, as well as detailed information about commitments and performance in relation to local content targets.

This is an area where there is great scope for enhanced collaboration between government, business and civil society. Developing and delivering cutting edge practices that bring real social and environmental improvements in the oil and gas sector is ultimately to the benefit of all.