

energy transactions

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Kazakhstan's New Trunk Pipeline Law

New law gives the RK government additional control over new trunk pipeline projects.

After many changes, extensive negotiations, and numerous interim drafts, the Republic of Kazakhstan (RK) has enacted a Trunk Pipeline Law (Pipeline Law). The new Pipeline Law, which came into effect on 3 July 2012, is the first distinct RK law governing trunk pipelines.¹ Previously, the construction, ownership, and operation of trunk pipelines were regulated by a number of different laws, such as the Subsoil Use Law, the Petroleum Law, and various statutory provisions. The recently adopted Pipeline Law is meant to provide a new unified legislative base for the construction, ownership, and operation of trunk pipelines and is a further step in the RK government's effort to exert control over strategic areas of the RK economy.

The purpose of this LawFlash is to highlight the key changes introduced by the Pipeline Law and some of the questions that arise along with it.

The Republic of Kazakhstan Given Priority Right over All New Trunk Pipeline Projects

The RK will have a priority right to an interest of no less than 51% in new trunk pipeline projects. The priority right gives the RK the right to jointly participate with investors in the creation and/or construction of new trunk pipelines.

To enable the state (represented by the RK government) to exercise its priority right, an investor intending to construct a new trunk pipeline must submit its commercial proposal concerning the RK's participation in trunk pipeline construction to the Ministry of Oil and Gas (MOG). The investor's proposal should include (i) information regarding the cost of the project along with details on how the cost was calculated and (ii) technical characteristics of the trunk pipeline.

The RK government has 30 business days after receipt of the commercial offer from the MOG to exercise its priority right. The MOG will then notify the investor of the RK government's decision within five business days from when it is taken. If the RK waives its priority right or the MOG does not timely notify the investor, such investor is permitted to participate, develop, and construct the trunk pipeline independently or with any other party on terms and conditions not more favorable than those offered to the RK.

While the RK will hold its interest through a national company, it is unclear whether the RK priority right to participate in trunk pipeline "projects" means it has a priority right to acquire an interest (shares) in legal entities owning trunk pipelines or to-the-trunk pipelines. It is safe to assume, however, that the intent of the lawmakers was to extend the RK priority right to both share and asset deals. Time will tell how this rule will be applied in practice.

The Pipeline Law also suggests that the RK's priority right is not fixed at 51% or more. Rather, the government may also choose to have less than a 51% participation in a trunk pipeline projects. This flexibility gives the RK some options as to the amount of its interest and may benefit investors.

It is not yet clear under the Pipeline Law what role the RK will have in financing the project. The Pipeline Law is

1. The trunk pipelines cover oil, gas, and oil-product pipelines.

silent on many such issues, and we may not receive a clear picture of how certain provisions of the Pipeline Law will work until the necessary supporting rules and regulations have been adopted.²

The only exemption to the RK's priority right is in relation to the expansion of existing trunk pipelines. At this point, it is not clear how broadly this exemption may be interpreted and applied. For example, will the exemption apply only to trunk pipeline extensions that are physically connected to an existing pipeline? If not, will it also be applied to new trunk pipelines that are commonly owned but not actually physically connected, or to the reorganization (e.g., merger) of legal entities resulting in the expansion of a trunk pipeline? It is clear, however, that existing trunk pipelines, such as the Caspian Pipeline Consortium (CPC), will be "grandfathered" and so will benefit from this exemption.

The Pipeline Law also does not address existing transit and/or cross-border international trunk pipelines that run through the RK. It would be reasonable to assume that such trunk pipeline projects would also be exempt from the RK's priority right under the relevant international treaties.

The Republic of Kazakhstan Has Priority Right to Acquire "Strategic Objects"

The Pipeline Law mirrors provisions of the Civil Code and National Security Law that give the RK approval and priority rights in connection with the alienation of trunk pipelines and direct or indirect interest in "strategic objects"—property of strategic importance to the RK that may have an impact on the national security of RK. The provisions of the Pipeline Law relating to the priority right of the RK with regard to the trunk pipelines being strategic objects are not novel, having been in effect since 2007.

Powers of the National Operator³

The Pipeline Law provides that, for trunk pipelines where the RK, national management holding company, or national company directly or indirectly owns 50% or more shares or participatory interest, operator services must be provided by the RK national operator, unless the RK government decides to authorize another legal entity (in which the RK, a national management holding company, or a national company owns 50% or more shares or participatory interest) to provide such services in order to comply with international treaties. Thus, the Pipeline Law acknowledges the supremacy of ratified international treaties over domestic law; therefore, if an international treaty gives operator's rights to a party other than the national operator, the 50% RK-affiliation rule will not apply. The RK's use of its right to appoint an operator may undermine commercial agreements between parties of non-ratified international treaties or intercompany agreements that provide for a non-national operator.

Other Notable Provisions

- **Product quality bank.** The Pipeline Law also enables the establishment of a product quality bank and empowers the MOG to, among other things, establish "rules for the operation of a product quality bank." A product quality bank is similar to an "oil quality bank" that represents the mechanism of mutual cash settlement among shippers depending on differences in product quality parameters transported via pipelines. The establishment and operation of such a product quality bank may potentially be burdensome for certain companies that would need to compensate or earn lower revenues due to the lower-quality parameters of the products transported.
- **Equal access and order of priority in providing pipeline services.** The Pipeline Law, as well as the current legislation on natural monopolies, provides for the right of shippers to equal access to trunk pipeline

2. By order dated 3 August 2012, the RK Prime Minister ordered the government to adopt a number of supporting rules and regulations by the end of August 2012.

3. A national operator is a legal entity determined by the RK government—the controlling share of which is owned by the state, a national management holding company, or a national company—which owns or otherwise legally holds one or more pipelines.

services if there is free throughput capacity, subject to statutory limitations.⁴ If there is limited throughput pipeline capacity, oil and oil-products transportation services are rendered in the priority established by the Pipeline Law, where first priority is given to shippers supplying oil to domestic refineries. In furtherance of the abovementioned first priority, the Pipeline Law also provides for the possibility of exchange (swap) operations⁵ for the purposes of supplying oil to domestic refineries and gas to the domestic market and/or outside the RK, upon written consent of the pipeline owner (or other person legally holding rights to pipeline) and the MOG.

- **Ownership.** The Pipeline Law provides that trunk pipelines may be state or privately owned, with the exception of individuals and foreign legal entities.

Given that the Pipeline Law has been enacted very recently, the relevant practice is not developed, and it is yet to be seen how the RK government will enforce the applicable rules. By analogy with the Subsoil Use Law and the Gas Law, we note the general trend is for the government to enhance its authority over key industries, including trunk pipelines.

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4. Article 24.1 of the Pipeline Law.

5. Exchange (swap) operation is the exchange of products of one shipper for the products of another shipper based on the written agreement executed between the shippers, which is carried out in case there is no free throughput capacity of one pipeline or availability of throughput capacity of another pipeline.