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CASPIAN INVESTOR™

Kazakh Government Considers Caspian Sea Shelf as Strategic Resource

Interview with Minister Vladimir Shkolnik

By Inna Gaiduk

Kazakhstan has become one of the most influential states in the Eurasian space, holding the key place in tackling all major issues of contemporary world politics in this region. The shelf holds a place of prominence in the future of the country's oil and gas sector. The results of survey and prospecting operations conducted in the past few years showed that the main increases in recoverable reserves and hydrocarbon production should be expected to come from new fields in the Kazakh sector of the Caspian Sea. Preliminary estimates put recoverable reserves of Kazakhstan's Caspian Sea shelf at more than 13 billion tons (100 billion barrels). But the success of the program to develop the Kazakh sector of the Caspian Sea is contingent to a considerable extent on the investment climate in the republic, positive changes in the Kazakh legislation on subsoil use and taxation issues and on solving the problem of export of the energy resources.

Kazakhstan's Minister of Energy and Mineral Resources Vladimir Shkolnik agreed to answer questions from Caspian Investor on prospects for growth in foreign investments in projects on the Caspian Sea shelf, as well as on other pressing issues affecting developments in Kazakhstan's oil and gas sector.

Caspian Investor: Foreign investors eagerly await the first offshore tenders for Kazakhstan's Caspian shelf. When will the subsoil developers get the majority of prospective blocks? In which cases will the offshore contracts be signed without tenders through direct negotiations? Does Kazakhstan plan to continue attracting foreign partners to help develop its Caspian blocks together with KazMunaiGaz or will some of them be developed independently? With which potential investors and on which blocks are negotiations going on now?

Vladimir Shkolnik: The Government of Kazakhstan considers its Caspian shelf a strategic resource which will not only help turn the country into one of the leading producers of hydrocarbons, but will also serve as the driving force for the development of the overall economy.

Already, legislative steps have been taken to strengthen the role of the government in developing offshore oil and gas infrastructure.

In May 2003, a decree by the President of Kazakhstan approved the "Program on the Development of Kazakhstan's Sector of the Caspian Sea," which defined the mechanism and terms for subsoil use.

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Today, subsoil rights can be acquired either through tender or direct negotiation with KazMunaiGaz National Oil and Gas Company. In order to support the national interests and increase participation by Kazakh businesses in developing oil and gas fields KazMunaiGaz is given the right to at least 50 percent in offshore projects.

According to existing regulations, the Government determines which blocs are put out for tenders on an annual basis. Currently, the Government is reviewing proposals on a list of blocs which can be put out for tenders in 2006.

The Republic of Kazakhstan is actively working on attracting investors in the oil and gas sector. On July 6, Kazakhstan signed a production sharing agreement (PSA) with Rosneft oil company of Russia for the Kurmangazy project. Work is ongoing with the Korean Consortium of the Caspian Oil Project on the project at the Zhambyl bloc. A number of memorandums of mutual understanding have been signed with companies such as Wintershall of Germany, OVL of India, and Statoil of Norway. In addition, a number of other proposals from foreign companies are under review.

Caspian Investor: A number of foreign investors, potential participants in offshore projects in Kazakhstan's Caspian sector, consider the current tax regime for offshore blocs unprofitable considering the higher risks. At the end of 2004, the Government of Kazakhstan introduced amendments to tax legislation reducing its share in PSA contracts. How much does this change increase the attractiveness of Kazakhstan's Caspian shelf for foreign companies? Are there any other changes in view to improve the tax regime for projects on the shelf?

Vladimir Shkolnik: The level of attractiveness of oil and gas projects depends on profitability. Profitability is directly

related to the tax regime set forth by Kazakhstan's law.

Our experience showed the taxation regime, which had existed in 2004, was too tough and that led to fewer contracts for subsoil use.

Taking this into consideration, at the end of 2004 a number of amendments were introduced in the Tax Code which reduced the government's share, such as changes in the means of calculation, reduction of bonus rates and setting of the mechanism for defining the value of products. As a result of these changes, the tax burden on projects signed under the second model of the tax regime has been reduced. According to our preliminary calculations, these changes can raise the profitability of projects by as much as three or four percent.

In June 2005, our Parliament reviewed draft legislation "On amendments and additions to some legislative acts on taxation." This bill, in addition to other issues, will provide amendments to the Tax Code of Kazakhstan to reduce the tax burden for projects at small and medium sized fields, as well as for fields requiring large capital investment. If these amendments become law, profitability will be increased by an estimated 1.5 to 2 percent.

Therefore, the Government is moving to provide a more acceptable tax regime for subsoil users compared to the one of 2004.

The signing of the PSA agreement for Kurmangazy between the Ministry of Energy and Mineral Resources of Kazakhstan, KazMunaiGaz and Rosneft is based on the current Tax Code and is a result of the more equitable tax regime.

Negotiations are also taking place on the 'N' project in the south of Kazakhstan's sector and on the Zhambyl project.

Other projects defined as projects of first stage in the "Program on Development of Kazakhstan's Sector of the Caspian Sea" are being examined.

At the same time, under the current tax regime, small and medium sized projects in the oil and gas sector do not achieve an acceptable level of profitability. To solve this problem, the Government of Kazakhstan has developed proposals providing for some flexibility in the tax regime when the Government signs a PSA.

The proposed changes will increase profitability for most of small and medium sized projects and increase their attractiveness to investors significantly.

Caspian Investor: KazMunaiGaz is currently developing offshore structures at Atashskaya and Tub-Karagan together with the Lukoil company of Russia. Recently, drilling on the first well at Tub-Karagan showed negative results. Can you comment on that?

Vladimir Shkolnik: Drilling of the first exploratory well at Tub-Karagan is being done in order to explore geological structures, discover hydrocarbons and to determine their commercial potential. Drilling started April 30 of this year.

The drilling of the well is being done in full compliance with technical specifications, and accompanying geological and technological controls and geological and geophysical studies of the site. Environmental monitoring is also in place.

Currently, the well has been drilled to a project depth of 2,500 meters. A comprehensive set of geological and geophysical studies has been carried out on the revealed profile, as well as laboratory studies and analysis of the core sample and extracted sludge. In order to obtain comprehensive geological infor-

Curriculum Vitae: Vladimir Shkolnik

Experience:

January 2004 – Present: Minister of Energy and Mineral Resources of the Republic of Kazakhstan

2000-2002: Deputy Prime Minister – Minister of Energy and Mineral Resources of the Republic of Kazakhstan

1973-2000: After graduating from the institute, he worked his way up from engineer-physicist to deputy head of the laboratory, deputy chief engineer and deputy director of the Mangyshlak energy integrated plant. He was appointed general director of the Republic of Kazakhstan's Nuclear Energy Agency, Minister of Science and New Technologies, Minister of Science – President of the Republic of Kazakhstan's Academy of Sciences, Minister of Science and Higher Education, Minister Energy, Industry and Trade of the Republic of Kazakhstan.

1966: He started his career as radio equipment controller at the Serpukhov radio plant in the Moscow Region.

Education:

1973: Graduated from the Physical-Energy Department of Moscow Engineering-Physical Institute

He holds a doctoral degree in physics and mathematics and the title of professor.

Personal:

Born in 1949.

mation on the well more detailed industrial and geophysical studies continue.

The work of drilling this exploratory well at Tub-Karagan is not yet finished and so it is too early to draw any conclusions.

Exploratory work was done on the Atashskii bloc in 2004. Two dimensional seismic studies were carried out there over 1,057 linear kilometers.

The data from seismic studies, including both new and archival materials for a total of 1,772 linear kilometers, has been processed and interpreted by experts. The geological profile for the Atash structure has been prepared based on these works. The placement of a future well has been approved and projected reserves of hydrocarbons have been calculated.

To reduce geological risks of drilling an exploratory well, additional research is set for the Atash bloc. This research includes electronic exploratory works over 500 linear kilometers, two dimensional seismic studies covering 400 kilometers and three dimensional seismic studies over 360 kilometers, as well as a comprehensive analysis of geological and geophysical factors.

The results of these analyses will be used to make a decision on drilling an exploratory well at Atash.

Caspian Investor: How do you view the cooperation with Russia regarding gas? Currently Kazakhstan and Russia are negotiating about exporting of Kazakh gas to Europe. What are Kazakhstan's requirements and how big a probability is there Gazprom will give direct access for gas from Kazakhstan to the European market? When will the joint venture be created at Orenburg gas refinery between KazMunaiGaz and Gazprom? On what conditions? Will this make build-

ing your own gas refinery at the Karachaganak field redundant?

Vladimir Shkolnik: Kazakhstan and Russia are now discussing the possibility of creating a 50-50 joint venture at the Orenburg gas refinery in Russia to refine gas from the Karachaganak field and fields in the Orenburg region.

Gazprom and KazMunaiGaz have established a working group and developed a work plan envisioning discussions over the establishment of the joint venture. The results of these discussions will determine the decision for the choice of processing Karachaganak gas.

Caspian Investor: Last April, Kazakhstan purchased 50 percent of BG's share in the Agip KCO international consortium developing Kashagan and other structures. How will the presence of KazMunaiGaz, representing Kazakhstan, influence further development of the project? Will there be any changes in the strategy of the consortium?

Vladimir Shkolnik: Several factors determine the development of this project.

Consortium participants act in accordance with a PSA agreement. It defines major responsibilities of each participant and is a legal basis for planning the stages of the project's development. Among the most important stages are the working programs to explore, assess and plan the development of Kashagan according to approved annual working programs.

KazMunaiGaz has the same rights and obligations as other Consortium participants. It enjoys no special privileges over other participants.

Participation of the national company in the project has moved it to a new level since there is now better understanding of industrial and organizational matters and a new kind of business relationship

between KazMunaiGaz and the partners.

In addition, participation in the project will allow Kazakhstan to build equal partnership relations with other countries through demonstrating the transparency of the oil and gas industry of Kazakhstan and the qualifications of Kazakh specialists of international standards, as well as a commitment to multi-dimensional policies in developing our economy.

Caspian Investor: Kazakhstan has already used fully its quota for shipping oil through the Caspian Pipeline Consortium's (CPC) pipeline. Producers in Kazakhstan demand expansion of its throughput capacity. What are the prospects for expanding this pipeline to 67 million tons of throughput capacity? Russia insists on further tariff increases for shipping the oil through CPC, but Kazakhstan is opposed to this. What kind of a compromise do you think can be achieved here?

Vladimir Shkolnik: Quotas for shipping oil through the CPC system are allocated among CPC shareholders in accordance with a shareholder agreement and are calculated providing the expansion of the pipeline's throughput capacity to 67 million tons a year.

The increase in the throughput capacity will allow Kazakh oil producers to ship about 50 million tons of oil a year through the CPC. To compare, in 2004, Kazakh producers shipped 21.8 million tons of oil through the CPC.

Raising the tariff for shipping oil through the CPC is one of the conditions for CPC expansion, and currently CPC shareholders have reached a compromise to raise the tariff by two and a half dollars in September 2005.

Caspian Investor: The Baku-Tbilisi-Ceyhan (BTC) export pipeline was

opened last May. What are the prospects Kazakh oil will flow through it this year and in the future? Chevron has announced intentions to ship through BTC about 2 million tons of Kazakh oil. Which other exporters are potential suppliers for this route? When will the final agreement be reached and when will the agreement be signed on Kazakh oil exports through BTC with the Azeri side? Will this route not become a competitor of the Kazakhstan-China oil pipeline currently under construction, as well as for the expanded pipelines of Atyrau-Samara and CPC?

Vladimir Shkolnik: Four participants in the North Caspian project at Kashagan, ENI, Total, Inpex and ConocoPhillips, acquired a total of 15 percent participation in the BTC pipeline in 2002. Upon becoming a participant in the North Caspian project in 2005, KazMunaiGaz may also use the BTC route for shipping its oil to international markets.

If Chevron's bid to buy Unocal is successful, Chevron can get 8.9 percent in the BTC project. Chevron will work out the terms and timeframe for shipping its oil through BTC with the BTC Co. on commercial grounds.

All of the above points to the intentions of Kazakh producers to ship their oil to world markets using the BTC pipeline.

Today, negotiating teams of KazMunaiGaz and the State Oil Company of the Azerbaijan Republic (SOCAR) are working to draft an agreement between Kazakhstan and Azerbaijan to encourage and support the shipping of Kazakh oil through the Caspian Sea and the territory of Azerbaijan. Main provisions of the draft agreement have been approved; issues of legal nature are being finalized.

Kazakhstan plans to raise its oil production to 150 million tons annually by 2015.

Estimated internal consumption will grow to 15 million tons of oil annually. Given the planned expansion of the CPC pipeline to 67 million tons annually including the 46 million tons throughput capacity reserved for Kazakhstan, as well as the expansion of the Atyrau-Samara pipeline to 20-25 million tons annually and of the Kazakhstan-China pipeline to 20 million tons annually, as well as available maritime transportation from Aktau of 10 million tons annually, the export facilities will not be sufficient to export all the oil which will be produced in Kazakhstan.

In light of the above, shipping Kazakh oil through the BTC pipeline is an additional and necessary route and can in no way be viewed as competing with the Kazakhstan-China pipeline.

***Caspian Investor:* An agreement has been reached to ship up to 6 million tons of oil annually to Ukraine through the Baku-Tbilisi-Supsa pipeline. Of this amount, Kazakh oil will constitute 50 percent, Turkmen oil will account for 30 percent, and Azerbaijan will supply 20 percent. Oil will be shipped by tankers from Supsa to Odessa. The goal is to fill the Ukrainian oil refineries. In the future, further expansion of oil supplies is planned, including shipping through the Odessa-Brody pipeline directly. What are the prospects for the Baku-Tbilisi-Supsa and Odessa-Brody pipelines? How effective economically is this scheme altogether, and who will buy the Kazakh oil?**

Vladimir Shkolnik: With the commissioning of the Baku-Tbilisi-Ceyhan pipeline, Kazakhstan has an opportunity to also use the Baku-Supsa pipeline to export its oil.

The Kazakh oil shipped through Baku-Supsa can be shipped onto Ukraine and in the future, through the Odessa-Brody-Plotsk pipeline, as well as through other routes around the Turkish Straits.

We know Ukraine and Azerbaijan are currently discussing cooperation in shipping Azeri oil to Ukraine through Baku-Supsa for further shipment through Odessa-Brody.

As far as the Kazakh oil shipments are concerned, Kazakhstan is currently reviewing the possibility of shipping oil through Baku-Supsa. This issue needs further review. □