

Enhancing FDI inflows into oil and gas industry, case study of Kazakhstan and Uzbekistan

Jamola Khusanjanova

Abstract. In this paper authors look at the role of FDI to oil and gas industry and its role for development in developing countries in a case study of Kazakhstan and Uzbekistan. This paper examines FDI to oil and gas industry as well as legal framework and concludes with some policy implementations for improving investment attractiveness.

Key words: FDI, oil and gas, legal framework

1. Introduction. Background information

During the past two-three decades, the role of foreign direct investments (FDI) has become more and more important, especially for developing countries. In order to enhance their investment attractiveness countries started to take actions to make investment climate more attractive such as making legal frame more investors' friendly, decreasing taxations and etc. Although different in size and population Kazakhstan and Uzbekistan have some similarities as well. In addition to being major oil and gas producers in Central Asia, both of these countries are former members of Soviet Union under which they were considered as a resource base for 'the center'. Thus, even after becoming independent they continue dependence on their natural resources for their development.

During the Soviet times, Kazakhstan had, two main economic pillars: agriculture and livestock farming (over two-fifths of GDP in 1990) and coalmining and metal smelting [1]. Uzbekistan was providing cotton, gold, and hydrocarbons. Kazakhstan gained independence in 1991, the oil sector in the country confronted several handicaps, which were inherited from SU. The handicaps were resolved with the help of increasing FDI inflows in to sector, after adoption of market liberalisation and privatisation program in 1993 by the government of Kazakhstan [2]. Uzbekistan preferred steps by step transition toward market liberalisation and privatisation which started from 1995 to dust their development.

As many developmental studies shows there are causalities between development and investment. This is significant in current case as both countries are still in transition and have their own backwards in development. Taking in to account major role of oil and gas sector in economy of both country I think it is vital to look at ways of enhancing investment activity in oil and gas industry

2. Foreign Direct investment in Kazakhstan and Uzbekistan after independence

Kazakhstan is the second largest oil producer in the CIS (after Russia). It is 30st among the world's 90 oil-producing countries. Moreover, Kazakhstan has the Caspian Sea region's as well as Central Asian's largest crude oil reserves. According to the USA Energy Agency its extraction capacity accounts for over 2.8 million barrels per day. Therefore, oil export became the basis of the country's economy after its independence [3].

According to the data from 'The World Oil Outlook' Uzbekistan is one of the richest countries in Central Asia for oil and especially for natural gas. That puts it in top ten countries according to the natural gas reserves [4]. Uzbekistan has over 205 hydrocarbon fields including 96 oil and 109 natural gas fields, with estimated reserves counted for over next 75 years with current extraction volume [5].

Rich oil and gas resources, as well as export of natural resources provides growth of Kazakhstan's GDP, which on average grew about 9 percent during 2003 - 2007. However, although Uzbekistan exports less oil and gas, its GDP growth rates are higher compare to Kazakhstan.

<Figure 1 about here>

Both Kazakhstan and Uzbekistan after independence start to attract foreign capital to their economy. However, due to different circumstance, this process had different outcomes and scales in both countries. While both countries have received FDI, the investment amounts have differed markedly. Cumulative FDI amounts into Kazakhstan from 1993 to 2005 were over US\$19 billion; Uzbekistan's cumulative FDI amounts for the same time period were US\$1.3 billion [6]. Graph 2 indicates these differences in share of FDI in GDP of both countries.

The reason of existing differences in FDI amount is that both of the countries have different approaches to the legislative framework. On one hand Kazakhstan had started its market liberalization earlier, with rapid and dynamic changes in all related areas. Consequently, the government of Kazakhstan had adopted series of legislative acts and law which has shaped its legislative framework, and improved its investment attractiveness.

<Figure 2 about here>

On the other hand, Uzbekistan took step by step approach to liberalise its market. Therefore, it managed to keep its market relatively less liberal for certain period. In Uzbekistan first acts regarding to the enchasing investment attractiveness and improvement of investment climate were done by adopting series of act and laws mainly starting from 1996-1997. The most important of them are:

- the law of Republic Uzbekistan 1998, № 609-1 "About foreign investments";
- the law of Republic Uzbekistan 1998, № 611-1 "About guarantees and measures of protection of the rights of foreign investors";
- the law of Republic Uzbekistan 1996, № 263-1 "About external loans";
- the law of Republic Uzbekistan 1994, "About bowels";
- the law of Republic Uzbekistan 1998, № 719-1 "About investment activity";
- the decree of the President of Republic Uzbekistan 1998, "About measures on perfection of the mechanism of realisation of projects with foreign investments";
- the decree of the President of Republic Uzbekistan 2000, "About measures on attraction of direct foreign investments into investigation and an oil recovery and gas";
- the decision of the Cabinet of Republic Uzbekistan № 1 from 2000, "About the state monitoring of a course of realisation of the projects included in the investment program of Republic Uzbekistan"

It should be noted that in case of Kazakhstan those legislative acts were adopted and implemented much earlier.

3. Legal framework

While taking closer look in particular at legal acts which shape legal framework of both countries in oil and gas industries differences can be noted as well. Regarding to the legal framework of Kazakhstan, there are two main pieces of legislation regulating foreign investment into the energy sector. One is "Republic of Kazakhstan Law on Petroleum" (June 1995) and the second is the "Law on surface and use of subsurface" (January 1996). Both laws have been changed since their acceptance and became much liberal [2].

The sub surface law outlines the rules and regulations for an investor to acquire a subsurface use right. In Kazakhstan's legal framework the subsurface use right is the equivalent to a license or concession in other jurisdictions [2]. In oil and gas projects, it is grounded upon execution of a "Hydrocarbon contract" between the "Complementary body", i.e the Kazakhstan Ministry of Energy and Mineral resources and the producer known typically as a "Contractor". Existing petroleum law is some ways an addendum to the subsurface law in that it regulates oil and gas projects only. Moreover, oil and gas companies in Kazakhstan are privatized

and act independently from each other. They are characterized as horizontally integrated companies, some of which are even owned by foreign investors.

In a contrast with Kazakhstan oil and gas companies, Uzbekistan's oil and gas producing companies are state owned and gathered in the vertically integrated "Uzbekneftegas" national holding company. It is the only actor in Uzbek legislation, which is authorized to sign oil and gas exploration contracts with foreign companies. [?] It acts as a participant in joint ventures and supervises all petroleum operation within country [6]. Moreover, this company is state nominated as state co-venture in exploration and production ventures with foreign investors; also it is a 'Complementary body', which regulates oil and gas operations. Foreign investors however, might consider this type of dual role as both producer and regulator as a conflict of interest [7].

The legislative framework in Uzbekistan, in a contrast to Kazakhstan, is less liberal. For example, the articles 3-4 and 7 of 'Subsoil law' of Uzbekistan gives authority to the President, Cabinet Ministers, local authorities, and specially designed state agencies to terminate actions of foreign investors. In addition to these powers, article 4 of the law on natural monopolies also gives power to regulatory oversight for natural monopolies to the state. The law on subsoil (September 1994) and its amendments set out Uzbekistan's framework of statutes governing the exploration and development of all subsoil resources, including hydrocarbons and other minerals. Article 19 of the subsoil law provides many excuses for the government to terminate foreign investors' license on exploration and producing.

Perhaps, on one hand this type of authoritativeness in monitoring actions with FDI does lead to more benefits for the host country, consequently to more development. On the other hand it does not enhance investment attractiveness of the industry. Joint ventures on an oil recovery and gas, created with participation of the foreign companies which are carrying out search and prospecting works on oil and gas, are released from

- payments of the profit tax for a period of 7 years from the oil recovery or gas beginning. After the specified term the rate of the profit tax of the specified joint ventures is established at a rate of 50 percent from the current rate;
- obligatory sales of currency gains from realisation of production received from primary activity;
- payments of the tax to property and on incomes of foreign participants of individual share in joint ventures.

Thus, in Uzbekistan the attractive investment climate and favorable conditions for attraction of the foreign capital to oil and gas branch of the economy is growing.

In Uzbekistan unprecedented privileges to the foreign companies which have expressed desire to work in branches of thermal power station of the country have legislatively been fixed. For example, since May, 2002 in Uzbekistan it are given to foreign investors:

- The exclusive right on carrying out of resource searching activity and the subsequent working out of the revealed deposits;
- The right of priority to reception of new territory for continuation of works;
- The right of primary processing of raw materials, export of oil, gas and produced products;
- The right to reception in specially stipulated cases of compensation before the expenses suffered by the companies;

For the foreign companies considerable tax and customs privileges, up to full cancellation of all fiscal payments operating in the countries till the moment of a recoupment of the enclosed capital are entered;

Basically our findings from comparative case study of two countries suggest that, foreign direct investment lead to economic growth however, on order to reach its optimal outcomes certain conditions should be created. To the foreign investors realising investment projects in the territory of Republic of Uzbekistan, considerable privileges and stability of conditions of the agreement are guaranteed. However, as most of the literature suggest there is still numerous actions to be done.

For example, in Uzbekistan process of liberalisation still needs to be carried on. In terms of taxation system flexible taxation systems regarding to the richness of oil fields and season of year should be implemented.

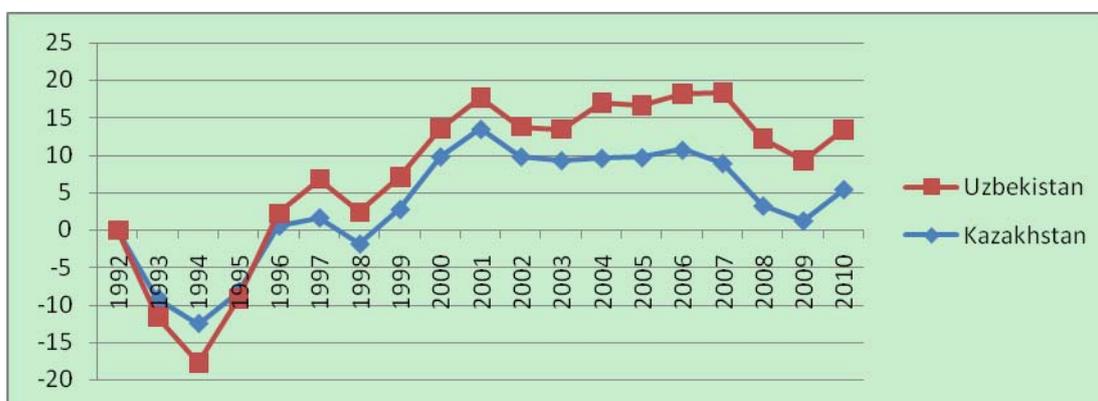
4. Acknowledgment:

This research was supported by WCU (World Class University) program through the National Research Foundation of Korea funded by the Ministry of Education, Science and Technology (Grant Number: R32-20077).

5. Bibliography:

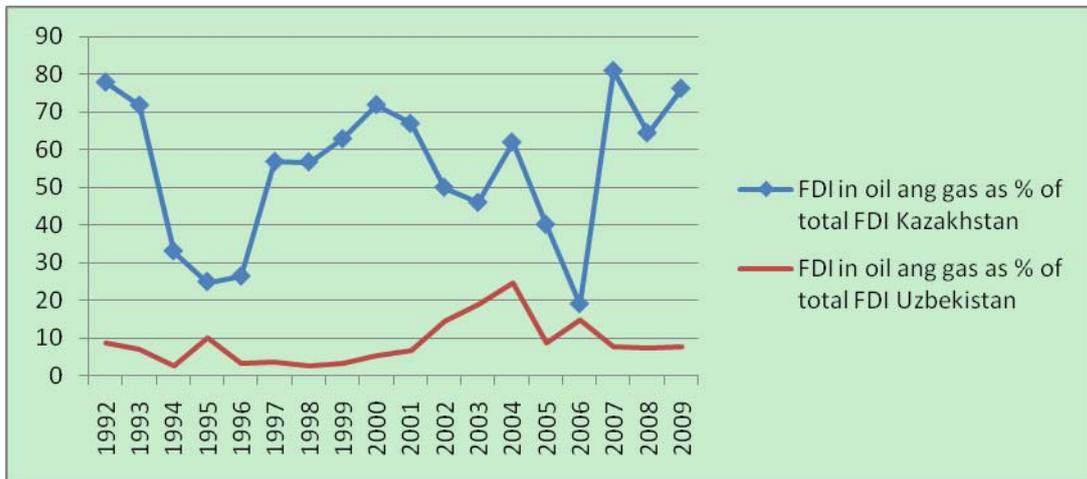
- [1] Pomfret, Richard (1995): *The Economics of Central Asia* (Princeton University Press, Princeton NJ)
- [2] Griffin Andrew T. (2008), “The January 2007 Amendments of Kazakhstan’s Petroleum and Subsoil Use Laws” DL Piper LLP, April.
- [3] Energy Information Agency 2009, “Kazakhstan Energy Profile,” <http://www.eia.doe.gov/> (accessed May 01, 2011)
- [4] OPEC World Oil outlook http://www.opec.org/opec_web/en/publications/340.htm (accessed August 24, 2011)
- [5] Uzbekneftegas 2009 - Working paper #134 by L. Ivonina – Uzbekneftegas
- [6] U.S. Department of Energy 2008, Energy Information Agency, “*Central Asia; Country Analysis Brief*” U.S. Department of Energy, <http://www.eia.doe.gov/> (accessed May 9, 2008).
- [7] Republic of Uzbekistan 1998, “Law No. 398-I: On Natural Monopolies,” (1998)
- [8] The decree of the President of Republic Uzbekistan from 28.04.2000 № VII-2598 «About measures on attraction of direct foreign investments into investigation and an oil recovery and gas», 4, 7.

Figure 1: Growth rate of Uzbekistan and Kazakhstan



Source: CIS data base

Graph 2: share of FDI to oil and gas industry as share of total FDI (%)



Source: UNCTAD database, local statistic agencies