

Protection of the Oil and Gas Investor's Rights in Kazakhstan

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The Government of the Republic of Kazakhstan has frequently made pronouncements on the sanctity of its contracts with foreign investors, including contracts with investors in the country's important oil and gas sector. These affirmations from the Government are encouraging. In a broader sense, Kazakhstan should be acknowledged for having adopted progressive legislation that seeks to protect the rights of foreign oil and gas investors. Unfortunately, throughout the past few years, Kazakhstan's Government has challenged the commercial and fiscal terms of major oil and gas contracts with foreign investors, which raises a range of thorny legal issues that foreign investors should take into account.

Early in 2003, Kazakhstan revoked its 1994 Foreign Investment Law that had stabilised the legislation applicable to foreign investors at the time they made their investment. The Republic replaced it with the 2003 Law on Investments, which, as discussed further below, provides less protection against changes in law. At the end of 2003, Kazakhstan amended its Tax Code to weaken tax stabilisation for oil and gas subsurface contracts.

In 2004, Kazakhstan's Parliament enacted the "priority right" amendment to the Subsoil Law, which gave the Republic a pre-emptive right to acquire an interest in any subsoil contract being offered for sale by an existing right holder, cutting off the rights of existing shareholders or consortium members whose contracts had allowed them first priority rights to acquire such interests. Kazakhstan broadened this right at the end of 2005, with the intention, it was widely understood, of being able to threaten the pending multi-billion dollar sale of an interest in a public company whose assets consisted chiefly of oil contract rights in Kazakhstan.

The process unfolding in Kazakhstan, whereby the Government with increasing boldness is challenging the sanctity of oil and gas contracts with foreign oil

companies, has antecedents throughout the history of foreign oil investment in developing countries. In Kazakhstan, as in other countries where foreign oil companies have held production rights, there are two types of threats to the sanctity of contract. The first is direct expropriation through the Government's repudiation of the exploration and production contract. This certainly poses a risk and is addressed below in the discussion of "direct" expropriation and nationalisation. However, the more typical threat to the commercial position of the oil and gas investor in Kazakhstan comes in the form of changes in tax legislation, changes to regulations on royalties and production share, the establishment of environmental fees or other regulatory levies, and imposition by regional or local authorities of special fees.

For example, in the middle of 2002, Kazakhstan became embroiled in a protracted standoff with prominent foreign oil and gas investors over the terms of a long-standing exploration and production agreement. The Republic also initiated a \$70 million environmental claim against these investors' Kazakhstan joint venture, based on regulations that did not exist at the time they signed their contract. Preserving the existing fiscal or other regulatory regime that existed when the foreign investor and the State entered into their contract, rather than direct expropriation or nationalisation, is what oil and gas investors often have in mind in Kazakhstan when referring to stabilisation of an investment or sanctity of contracts.

In view of these developments over the past few years, foreign oil and gas investors who have signed contracts with the State increasingly ask what type of Kazakhstan law and international law will protect their investments.

Under Kazakhstan's municipal laws, the right of the State to amend or repeal Kazakhstan's legislation, including stabilisation legislation, represents a constant threat to the stability of an investment. A threat exists that a tribunal will subordinate the investor's rights arising under its subsurface contract to the State's sovereign right to legislate and control the disposition of natural resources. To counter this risk, the foreign investor at international arbitration will want to craft an arbitration strategy that includes a broad range of Kazakhstan municipal law and international law causes of action to protect against, or compensate for, additional taxes, environmental impositions and other violations of the terms of the subsurface contract arising from a change in Kazakhstan law.

Protection of the investor's rights under Kazakhstan law

Governing law of the contract

The foreign party cannot designate the law of another sovereign state (for instance, English law, New York law) to govern the subsurface contract with Kazakhstan as a method of escaping changes to Kazakhstan law that override the fiscal and other administrative terms in the contract. The Petroleum Law provides that exploration and production contracts in Kazakhstan must be governed by Kazakhstan law.¹

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1 Law of June 28, 1995, No.2350, "On Petroleum", Art.53(1).

Arbitrators also would face difficulties under international law in applying foreign governing law provisions in contracts to issues that Kazakhstan considers as falling within the scope of its municipal law. It is unlikely that an arbitration tribunal would attempt to apply a foreign governing law provision to Kazakhstan tax, environmental, labour, health and safety, and other regulatory issues, which are subject to Kazakhstan law under its mandatory rules.²

Hence, even in the case of agreements that skirt the ambit of "oil and gas" contracts, Kazakhstan legislation will continue to govern the tax, environmental, and other administrative/regulatory matters—the typical areas in which the Government can effect a detrimental change in law.

Protections under the Civil Code

Most Kazakhstan subsurface contracts contain provisions on royalties or production share, taxes, environmental protection and other "regulatory" or "administrative" provisions that have their source in Kazakhstan statutory law but are codified for each project in the subsurface agreement with the individual contractor. The subsurface agreement will also often contain some type of stabilisation clause.

A problem arises, however, where the Republic amends the underlying subsurface, taxation or other administrative legislation. The Republic will argue that changes in legislation governing these issues will supersede the provisions of a contract. The tension between the sanctity of the investor's oil and gas contract rights and the sovereign authority of the Republic to require that changes in legislation will take precedence over pre-existing contracts is the central concern of this article.

Generally, Kazakhstan's legislation on contracts, including provisions on liability for breach of contract, is set forth in Kazakhstan's Civil Code.³ The contract provisions in the Civil Code would, on their face, give confidence to an investor that the terms and conditions of its contract with the State are protected by legislation upholding the sanctity of contracts.

The Republic, however, might argue that under Kazakhstan law, natural resources, environmental protection and taxation are creatures of administrative law and are outside the scope of the Civil Code. Indeed, the Civil Code itself provides that where legislation on natural resources and environmental protection (such as the Subsurface Law, the Petroleum Law and the Law on Environmental Protection) provide a specific rule, the Civil Code does not apply as to that issue; and the Civil Code does not apply to tax issues except in instances in which the Tax Code specifically authorises the application of civil legislation to taxation.⁴

The foreign investor could challenge this view by arguing that once the Government places natural resources, taxation and other administrative provisions in a contract, these terms become enforceable

under contract law (i.e. under the Civil Code and other civil legislation). The subsurface contract in Kazakhstan is a hybrid of civil and administrative legislation. The Tax Code, Art.282, expressly authorises the Government to place fiscal and regulatory terms in subsurface contracts. A good argument can be made that this subjects the natural resources, tax and other administrative terms in the contract to the requirements of the Civil Code just like any other term in a contract.

Stabilisation of contracts under Kazakhstan law

Stabilisation provisions in contracts and laws are designed to lock in place the fiscal and other terms of the petroleum contract and the legislative regime that applies to the contract. As such, they may provide some protection to the foreign investor to withstand changes in natural resources and tax law. Unfortunately, the Republic of Kazakhstan has been amending its legislation over the past few years to weaken stabilisation protections, especially in the Tax Code and in foreign investment legislation. This in turn impacts on the enforceability of stabilisation clauses in subsurface contracts.

Weakening of stabilisation legislation

Tax Code

Until its amendment in 2003 and 2004, the Tax Code contained a quasi-stabilisation provision, which provided that taxation terms in a subsurface contract may be "amended" in accordance with changes in legislation *by agreement of the parties* (i.e. not unilaterally by the State).

Article 282(1) of the amended Tax Code states that taxes under non-production sharing agreements will be calculated based on tax legislation "valid at the moment that obligations for their payment arise". However, Art.282(2) states that for subsurface contracts that have undergone obligatory tax review, the tax terms set forth in the contract entered into before January 1, 2004 can be amended only upon agreement of the parties.

With respect to production sharing agreements, the Tax Code provides in Art.285(1) that the fiscal terms set forth in such agreements may be amended in connection with a change of tax legislation upon agreement of the parties. However, part 2 of the same Art.285(1) stipulates that where the legislative change benefits a contractor, fiscal terms of a production sharing agreement should be amended to restore the original economic interests of the State. In contrast, under Art.285(2) of the Tax Code, where the legislative changes result in the abolition of any taxes stipulated in a production sharing agreement, the contractor continues to pay such taxes until both the contractor and the State agree to amend the production sharing agreement. Accordingly, Kazakhstan tax stabilisation law has become increasingly ambiguous, creating less certainty on the mechanisms for stabilising the fiscal terms in the investor's exploration and production contract.

2 See Ian R. Brownlie, *Principles of Public International Law* (6th edn, Oxford University Press, 2003), pp.36–41 (discussion of issues of municipal law before international tribunals).

3 Civil Code of the Republic of Kazakhstan, Arts 349–366.

4 *ibid.*, Arts 1.3 and 1.4.

Foreign Investment Laws

Turning to stabilisation provisions in Kazakhstan's foreign investment legislation, Kazakhstan's Parliament, as noted above, repealed its 1994 Foreign Investment Law and replaced it with the 2003 Law on Investment. The 1994 Foreign Investment Law had provided for stabilisation against a worsening of a change in law, requiring that the law in force at the moment of making the investment would continue to apply. In contrast, the 2003 Law on Investment does not provide an explicit guarantee against a change of law. It merely states that the "Republic of Kazakhstan guarantees the stability of the conditions of contract concluded between investors and state bodies of the Republic of Kazakhstan . . .".⁵

The 2003 Law on Investment's mere promise of stability of contracts, without any reference to guarantees of immunisation against changes of law, creates a risk that the State will interpret this provision merely as a promise not to compel an amendment to the text of the contract itself and does not insulate the investor from changes to law.⁶

Petroleum and Subsoil Laws

The Petroleum Law, Art.57, and the Subsurface Decree, Art.71, provide that the law in effect at the time the parties enter into a given subsurface contract will apply and that future changes in laws will not apply retroactively to that investment, subject to certain enumerated exceptions. The exceptions include amendments to the legislation of the Republic of Kazakhstan in the areas of defence, national security, and environmental safety and public health.⁷

Production Sharing Law

Kazakhstan adopted a production sharing law (the "PSA Law") in July 2005. Article 25 provides that if new legislation is introduced that deteriorates or improves the commercial results of the contractor's activities under a PSA, amendments shall be introduced to ensure a commercial result for the contractor that would have occurred under the legislation in force when the PSA was signed.

The PSA Law's provisions mark a disturbing legislative evolution that could also be observed in the amendments to the Tax Code, discussed above. Whereas the Petroleum Law and Subsoil Law call for a complete freezing of the legislative regime at the time the parties entered into the subsoil contract, the PSA Law, although purporting to seek a stabilising outcome, requires amending the contract. This opens the door to reinterpretation of the contract.

Contractual stabilisation clauses rely upon legislative stabilisation

The weakening of stabilisation legislation is significant because a stabilisation clause in a subsoil contract

would not, alone, assure protection of the foreign investor against changes in law. A good argument can be made that Kazakhstan civil law principles dictate that only Kazakhstan stabilisation legislation could stabilise the terms of contract. Under Kazakhstan municipal law, applicability of laws is generally an issue to be dictated by public statute enacted by Parliament, not by a private contract with the Government. As we have seen, Kazakhstan stabilisation legislation pledges, in varying degrees, to stabilise investments; it does not grant the Government the right to negotiate and agree to stabilisation guarantees in contracts. Accordingly, the Republic might argue that under Kazakhstan law, stabilisation clauses in contracts are enforceable only if laws calling for the stabilisation of contracts and investments remain in Kazakhstan legislation.

Stabilisation protections against recent legislation

It is useful to consider how stabilisation legislation may or may not protect against changes to Kazakhstan law enacted during the past year and a half.

The Government's "priority right"

The priority right legislation, enacted in 2004 as an amendment to Art.71 of the Subsoil Law, purports to give the Republic the right to acquire an interest in an existing project over the rights of existing participants in that project. One of the most controversial aspects of the priority rights amendment is that it expressly applies retroactively. It states:

"in both new and previously signed subsurface contracts, the state shall have a priority right over another party to the contract, or over participants in a legal entity holding a subsurface use right, [to acquire a subsurface right]"

Kazakhstan's Law on Laws and the Civil Code allow for a new law to apply retroactively if the new law specifically states that it does. The fact that the priority right provision states that it applies to previous contracts does not mean that it overrides the stabilisation guarantees in the Subsurface Law, the Petroleum Law and in other laws. A good argument could be made that unless legislators repeal the stabilisation laws, they cannot circumvent those stabilisation laws by a simple clause in an amendment that states that it applies to previously concluded contracts.

The Republic seems to have sensed the vulnerability of its position when it drafted the priority rights language and sought to portray it as a national security measure, which, as noted, constitutes an exception to stabilisation under the Subsurface Law and the Petroleum Law.

New Arbitration Laws

At the end of 2004, Kazakhstan enacted two laws pertaining to arbitration: the Law on Arbitration and the Law on International Arbitration. Article 7.5 of the Law on Arbitration provides a list of exceptions under which arbitration between two Kazakhstan legal entities is prohibited. The most disturbing exception

5 Law of January 8, 2003, No.373-II, "On Investment", Art.4.3.

6 Arguably, the subsequent provisions of Art.4.3 suggest that this guarantee was meant to protect against changes in legislation. However, the replacement of express protections against changes in law with provisions that merely suggest such protection presents a risk to the foreign investor.

7 See Petroleum Law, fn.1 above, Art.57; and Subsurface Law, fn.1 above, Art.71.

to a right to arbitration is where the issue "affects the interests of the state".

Under the New York Convention, Art.V.2(a), if an issue is non-arbitrable under domestic law, recognition and enforcement of an arbitral award may be refused. Accordingly, it may be difficult to enforce a foreign arbitral decision in Kazakhstan that was issued pursuant to the subsurface agreement since the Republic could argue that it "affects the interest of the state".

A persuasive argument could be made that stabilisation legislation protects against the applicability of these deteriorating provisions of law. The subsurface user might enjoy protection under the stabilisation provisions in the Law on Subsurface and the Petroleum Law. There is no apparent exception under the Subsurface Law and Petroleum Law's stabilisation provisions that would apply to a right to arbitration.

Concluding comment on Kazakhstan law protections

Because of the weakening of stabilisation provisions in the foreign investment legislation and Tax Code, Kazakhstan law offers uncertain grounds for preventing the Republic from requiring the foreign oil and gas investor to pay higher taxes and environmental fees or to comply with other changes in legislation. When the foreign investor argues breach of contract, the Republic can argue that in legislating on subsoil, tax and environmental matters, it is acting in administrative areas that are excluded from the Civil Code's reach and that the State's power in these areas cannot be restricted by the contract. In the future, when the foreign investor tries to invoke the stabilisation protections under Kazakhstan's statutes, it may find that the Republic has so severely weakened those statutory stabilisation protections that little remains to stabilise the investor's contractual rights.

We now turn to the issue of whether international law provides protection if Kazakhstan law fails to do so.

Causes of action under international law

Sovereignty over natural resources versus foreign investment contract rights

The 1958 decision by the arbitration tribunal in *Saudi Arabia v Arabian American Oil Co* ("*Aramco*") is an early case highlighting the tension between the sovereignty of the State over its natural resources and the sanctity of a foreign investor's contract rights.⁸ In that case, the Saudi Government abrogated the terms of a 1933 concession agreement with a foreign-owned company that had held the exclusive right to transport the crude oil that it produced at its concession in Saudi Arabia.

The Saudi Government argued that any externally imposed restriction upon its right to exercise its administrative powers would constitute an infringement on

its sovereignty. The tribunal reached a contrary view, holding that Saudi Arabia had exercised its sovereignty to voluntarily bind itself to contractual obligations from which it could not escape by reinvoking its sovereignty.

The facts in *Aramco* can be distinguished from the regulatory scenarios that have, so far, arisen in Kazakhstan. However, *Aramco* remains valuable because it exemplifies the ongoing debate, especially in oil and gas arbitrations, on the relative weight and applicability of sovereignty over natural resources versus the importance of upholding contract rights.

Cause of action under international law for expropriation

State responsibility under international law for destruction of contract rights

The traditional international law rule is that breach of a contract between a state and an alien remains a municipal law issue and does not give rise to international liability. Brownlie states that "breach of a private contract is not an international wrong".⁹

While this position is true as a general principle, under certain circumstances tribunals have ruled that destruction of contract rights constitutes a form of expropriation under international law. The international law violation is distinct from and operates independently of municipal law. As one ICSID arbitration tribunal pertaining to a claim against Pakistan ruled, "whether there has been a breach of the BIT and whether there has been a breach of contract are different questions".¹⁰ The tribunal cited the ILC for the proposition that "[t]he characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law . . .".¹¹

Commentators underscore that the threshold remains high for establishing that state action rises to the level of an expropriation under international law rather than remaining a mere breach of contract under local law. One commentator [Lipstein] writes: "the failure of a state to fulfill a contractual obligation, unless a failure is confiscatory or discriminatory in nature, does not automatically result in a breach of international law . . .".¹²

Viewed in this light, it will prove challenging for the foreign investor in Kazakhstan to establish a violation of international law by the Republic for changes in tax, environmental and other administrative laws that contradict the terms of the investor's subsurface contract.

Indirect or "creeping" expropriation

Arbitration tribunals have developed a body of international law to address situations in which the

9 Brownlie, fn.2 above, p.549.

10 *SGS Societe Generale de Surveillance SA v Islamic Republic of Pakistan* (ICSID, Case No.ARB/01/13, August 6, 2003), p.49.

11 *ibid.*

12 K. Lipstein, "The Place of the Calvo Clause in International Law" (1945) XXII B.Y.B.I.L. 130, p.134, quoted in Marjorie Whiteman, *Digest of International Law* (1963), p.908.

8 *Saudi Arabia v Arabian American Oil Co* (1958) 27 Int'l L. Rep. 117.

state, through increased taxation, regulatory levies and coercion, may destroy the economic value of an investment without formally taking title to property or expressly repudiating a contract.¹³ These measures are generally referred to as indirect or creeping expropriation. In legal terms, indirect expropriation has occurred when the diminution of value is sufficient to conclude that there has essentially been a taking. Most of the bilateral investment treaties between Kazakhstan and other countries protect against both direct and indirect expropriation.

Distinguishing creeping expropriation from a police power action

The Republic of Kazakhstan, when it damages the economic position of the foreign oil and gas investor through changes in legislation, typically asserts that it is protecting public health, safety or national security, and therefore has no obligation to compensate the foreign investor. Under international law, the various forms of state action that deprive an alien of its property but do not constitute an expropriation and therefore do not require compensation typically are lumped together into the concept of "police power actions".¹⁴

The central question for the foreign investor in Kazakhstan in terms of expropriation is, at what point does the state's right to tax investors and impose environmental restrictions or penalties cross the line from a legitimate exercise of the state's police powers and enter into the realm of "creeping expropriation"? Creeping expropriation is hard to distinguish from a legitimate police power action because creeping expropriation tends to arise as a result of a state's exercise of its fiscal and regulatory powers—the precise areas in which legitimate non-compensatory police power actions typically occur. The extent of the alien's loss may not prove decisive. Typically, tribunals have found an indirect expropriation where regulation or taxation is tainted with confiscatory intent or where it produces an uneven result with no discernible public purpose.

Regulatory expropriation in Kazakhstan's oil and gas sector

In analysing possible instances of indirect expropriation of oil and gas investments in Kazakhstan, we examine four categories: (i) environmental; (ii) taxation; (iii) interference with ownership interests or managerial control; and (iv) coercion.

Environmental

An example of indirect regulatory measures in the environmental sphere in Kazakhstan was the Atyrau Oblast's \$70 million environmental claim in 2002 against the joint venture of foreign oil and gas investors, who were parties to a long-standing exploration and production agreement in western Kazakhstan. The State's claim was based on environmental regulations that did not exist at the time the investors entered into their subsurface contract with Kazakhstan. Furthermore, the Oblast utilised a

discretionary methodology for calculating the penalty and interest.

By analogy, in *Metalclad Corp v Mexico*, an ICSID tribunal found indirect expropriation as a result of the State improperly exercising its environmental protection powers—even though the relevant statute purportedly sought to protect a rare cactus.¹⁵ Cases such as *Metalclad* suggest that foreign oil and gas investors in Kazakhstan may find relief at international arbitration for creeping expropriation if the Republic's environmental sanctions deprive the foreigner of the value of its oil and gas investment and the Republic cannot convince the tribunal that environmental factors explain the detrimental state action against the investor.

Taxation

There are various instances in Kazakhstan of taxation measures that deprived foreign investors of pre-existing rights under an oil and gas contract. One example is the Republic's reinterpretation, starting in 2002, of certain provisions of the NCS PSA, which is the contract governing the development of "Kashagan", Kazakhstan's largest oil field and indeed one of the largest oil fields in the world. The Republic's reinterpretation of these provisions resulted in the denial of the VAT exemptions in the NCS PSA. At the same time, the Ministry of Finance cancelled the Tax Instruction for the NCS PSA, which had confirmed the VAT exemption. These actions impacted most severely upon hundreds of oil services companies and other subcontractors and resulted in numerous claims against the State.

The claims of the foreign investors may have found support under international treaty if the changes in tax treatment had deprived the investors of the value of their investments. For instance, the US-Kazakhstan bilateral investment treaty's ban against direct and indirect expropriation expressly extends to expropriatory taxation¹⁶ and this could be applied to the unilateral removal by the Republic of tax guarantees in a subsurface contract.

Interference with benefits of ownership or managerial control

The Republic initially adopted the "priority right" amendment to Art.71 of the Subsurface Law in 2004 to compel BG to sell its interest in the NCS PSA (for the development of the Kashagan oil field) to the Republic, rather than to the other members of the NCS PSA consortium with whom BG already had signed purchase and sale agreements.

For those consortium members in the NCS PSA who had agreed with BG to purchase the offered interest, an expropriation case might have been based on the prohibition of expropriating an "investment" without compensation. There are international arbitral cases, notably those occurring during the US-Iran claims tribunals in the wake of the 1979 Iranian revolution, finding indirect expropriation as a result of the state using its powers to impede the exercise

13 Restatement (Third) of Foreign Relations §712, cmt. g (1987).

14 Rosalyn Higgins, "The Taking of Property by the State: Recent Developments in International Law" (1982) 176 *Recueil des Cours* 259–348, p.330.

15 *Metalclad Corp v Mexico* (2001) 40 I.L.M. 36.

16 Investment Treaty With The Republic of Kazakhstan, US-Republic of Kazakhstan, May 19, 1992. 1992 U.S.T. Lexis 189.

of managerial control or ownership rights.¹⁷ A good argument could be made that having entered into the various purchase agreements with BG, the consortium members had made a separate and independent investment and that the Republic destroyed the value of that investment—indirectly through regulatory means—in contravention of the various investment treaties to which the Republic is a party.

Coercion

Kazakhstan's local and national authorities often initiate administrative and criminal proceedings against foreign investors for alleged malfeasance in the areas of taxation, environmental protection and in other regulatory spheres. The State's measures to achieve results are often coercive. Actual examples have included the late night visit by tax police in Atyrau Oblast to the home of the director of a major UK catering subcontractor due to its alleged underpayment of taxes; the threat to arrest the director of the subsidiary of a major Australian telecommunications company because of penalties incurred after Kazakhstan's telecommunications authorities failed to renew the company's licence and reregister the company; and the actual arrest of the director of the Kazakhstan subsidiary of a UK-based oil trading company, because the company allegedly had underpaid income taxes.

Each of these actions was coercive and might have been used, when combined with the other facts in the given case, to support a creeping expropriation claim. An example of a successful arbitration action by a foreign investor in another country, who was treated in this manner, was *Biloune v Ghana Investments Center*, in which the tribunal held that the Government had constructively expropriated the value of the claimant's interest. The case had elements of both physical coercion and debilitating application of regulation.¹⁸ The investor in Kazakhstan could argue that as in analogous arbitration cases in which the investor prevailed, the coercive tactics were elements of an indirect expropriation if they contributed to the destruction of the value of the foreigner's investment in Kazakhstan.

Concluding comments on creeping expropriation

The international arbitration cases cited above help in reaching an understanding of the dividing line between legitimate police power actions and creeping expropriation. An international arbitral tribunal would likely see as expropriatory any measures taken by the Republic of Kazakhstan, which are cloaked in regulatory form but lack a viable regulatory objective, and which have the consequence of increasing the State's commercial position in relation to a specific investment or industry while depleting the economic position of the foreign investor.

17 See *Starrett Hous. Corp v Government of the Islamic Republic of Iran*, 4 Iran-U.S.C.T.R. 122 (1983); *Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran*, 6 Iran-U.S.C.T.R. 219, p.226 (1984). See also *Harza Engineering Co v Islamic Republic of Iran*, 1 Iran-U.S.C.T.R. 499 (1982) and *International Technical Products Corp v Government of the Islamic Republic of Iran*, 9 Iran-U.S.C.T.R. 206, pp.240–241 (1985).

18 *Biloune v Ghana Invs. Ctr.*, reprinted in (1994) 95 Int'l L. Rep. 183, p.209 (Perm. Ct. Arb. 1993).

Causes of action under international law for non-expropriatory injury

In many of the cases of injury to foreign oil and gas companies in Kazakhstan, the size of the investment is so great that the damage, although involving tens of millions of dollars in losses, falls short of destruction of the value of the investment. The following international law causes of action that may apply in such instances.

Arbitrary or discriminatory impairment

The cause of action of arbitrary impairment may prove particularly applicable in arbitration against the Republic of Kazakhstan. For instance, as demonstrated in the case of the environmental fine discussed above, the method used for calculating a fee or penalty is often ambiguous. In addition, the instances described earlier concerning the threatened and actual arrest of foreign investors, as well as the unjustified refusal to provide a licence and renew a registration, were arguably arbitrary. Accordingly, even if such actions did not so diminish the value of the investment to the point where they constituted a taking, the foreign investors could have brought actions under international law for arbitrary impairment.

Discriminatory impairment would be more difficult to establish in Kazakhstan. The court in *Banco Nacional de Cuba v Sabbatino* ruled that "[w]hen a state treats aliens of a particular country discriminatorily to their detriment, that state violates international law".¹⁹ As shown by the *Aminoil* decision, discussed below, the claimant will face greater difficulty establishing discrimination where the type of work conducted by that investor is so unique that the tax or regulatory imposition impacts only that investor and there is no evidence of intent to discriminate.²⁰

"No less favourable" treatment ("national treatment")

The view that customary international law forbids a host state from affording less favourable legal treatment to aliens as compared to nationals of the host state, has enjoyed support for the past several decades from various legal scholars, tribunals and governments.²¹ Tribunals have often ruled that superior treatment of nationals over foreigners, rather than proof of discriminatory intent, constituted the key requirement for establishing a failure to provide no less favourable treatment.²²

The lack of an intent element in this cause of action may make it possible for the foreign investor to establish a violation of international law even where the Republic portrays the injurious state action

19 *Banco Nacional de Cuba v Sabbatino*, 307 F.2d 845, 866 (2d Cir. 1962), p.867.

20 Arbitration Tribunal: Award in the Matter of an Arbitration Between Kuwait and the American Independent Oil Co ("*Aminoil*") (1982) 21 I.L.M. 976.

21 Brownlie, fn.2 above, p.524, nn.29–31. Several recent "national treatment" cases have arisen under the North American Free Trade Agreement ("*NAFTA*"). See *S.D. Myers, Inc v Government of Canada*, Partial Award P 44 (ICSID, November 13, 2000); *Marvin Feldman v. Mexico*, Award P 71 (ICSID Case No.ARB/(AF)/99/1, December 16, 2002), both available at www.state.gov.

22 *S.D. Myers*, p.63; *Marvin Feldman v Mexico*, p.71.

in regulatory terms and the foreign investor cannot prove that the Republic intentionally sought to extract additional value only from the foreign investor as opposed to local investors.

Stabilisation clauses under international law

A question arises as to whether or not international law provides a basis for upholding a stabilisation clause in a subsurface contract if Kazakhstan's municipal law fails to do so.

The key issue that international tribunals have had to determine in terms of stabilisation, is whether a stabilisation clause in a contract prevents a state from exercising its normal power to expropriate upon paying just compensation. Governments have argued that such an outcome would violate the state's sovereignty over natural resources.²³

International arbitration tribunals have issued conflicting decisions. For instance, in *Texaco Overseas Petroleum Co and California Asiatic Oil Co v Government of the Libyan Arab Republic* ("TOPCO"), the arbitral tribunal held that "the right of a State to nationalise could not prevail over the stabilisation clause" of a concession contract. The sole arbitrator ruled that international law elements of the choice of law provision "internationalised" the contract, which, when combined with the stabilisation clause, placed the stabilisation right on the plane of international law. Echoing *Aramco*, the award stated: "Libya has, through an exercise of its sovereignty, undertaken commitments under an international agreement, which, for the duration, is the law common to the parties".²⁴

In *Kuwait v American Independent Oil Co* ("Aminoil"), which concerned an expropriation by Kuwait in the 1980s, the arbitration tribunal held that an agreement to stabilise an oil concession might be enforceable if such a stabilisation agreement only lasted long enough for the foreign investor to earn back the value of its investment. In *Aminoil's* case, that time period had passed. Thus, the tribunal ruled that Kuwait could nationalise the concession but should compensate Aminoil.²⁵

The *Aminoil* tribunal held that Kuwaiti law applied, but that Kuwaiti law incorporated international law which in turn compelled the tribunal to consider the effect of the stabilisation clause on the plane of international law. Redfern writes:

"The [*Aminoil*] tribunal's decision rests on traditional respect for the law of the State which is a party to the contract, yet takes account—through its express reference to public international law—of the protection which international law gives to the legitimate expectations of the foreign investor."²⁶

23 Brownlie, fn.2 above, p.554.

24 International Arbitration Tribunal: Award on the Merits in Dispute Between Texaco Overseas Petroleum Co/California Asiatic Oil Co and the Government of the Libyan Arab Republic ("TOPCO"), (1978) 17 I.L.M. 1.

25 See fn.19 above.

26 Alan Redfern, *The Arbitration Between the Government of Kuwait and Aminoil* (Oxford University Press, 1985), p.93.

TOPCO and *Aminoil* concerned the effect of a stabilisation clause disallowing direct expropriation, rather than the enforceability of a stabilisation clause that purported to protect a foreign investor against alterations to fiscal and regulatory legislation—the chief concern for the foreign investor in Kazakhstan. Still, these international law decisions provide guidance because both types of stabilisation clause constitute a contractual limitation on the state's right to subject persons in its jurisdiction to government regulation and to exercise unfettered sovereignty over natural resources within its territory.

The foreign investor in Kazakhstan might invoke these decisions for the proposition that a stabilisation clause in a foreign investment contract under certain circumstances constitutes a block against the state's normal sovereign power to apply changes in its fiscal and regulatory legislation to all persons on its territory. The chief problem, however, with attempting to extend these well-known cases in this manner is that the Republic is sure to argue that abrogation of a stabilisation clause does not, taken in isolation, constitute an identifiable violation of international law. *TOPCO* and *Aminoil* were cases in which a familiar international law cause of action—expropriation—had already been established.

In contrast, the Republic will argue that if the injury caused by enforcement of amendments to tax and environmental legislation falls short of an expropriation, and in the absence of arbitrary or discriminatory impairment or some other international law claim, the Republic's failure to honour a stabilisation clause in a contract constitutes merely a breach of contract, just like any other abrogation of a contract. As such, it remains a municipal law issue. The stabilisation claim is thus subject to all of the vulnerabilities as to the enforceability of stabilisation clauses under Kazakhstan law discussed earlier. It may prove difficult for the investor to persuade a tribunal that international law requires tribunals to uphold stabilisation clauses to the point of blocking the regulatory power of the state if no independently identifiable violation of international law has occurred.

Conclusion

A lesson that emerges from various arbitrations in which the investor prevailed is the usefulness of demonstrating that the state's breach violates domestic legislation as well as international law. In *Aramco*, although the arbitrators based their decision on international law, they found it important that the offending action of the state also violated municipal law.

Similarly, the claimants' lawyers in the *TOPCO* arbitration published an article after the award and settlement, in which they indicated that among the reasons why they succeeded in winning an award of restitution under international law was that in their pleadings they argued that restitution was consistent with Libyan law.²⁷

27 Robert B. von Mehren and P. Nicholas Kourides, "International Arbitrations Between States and Foreign Private Parties: The Libyan Nationalisation Cases" (1981) 75 *American Journal of International Law* 476, p.511.

Beyond the hotly debated theories of the exact scope of the internationalisation of contracts, virtually all tribunals are compelled to recognise the pervasive importance of municipal law. Arbitrators will be reluctant to enforce a contract right and award a remedy if no basis exists for the award under the municipal law of the country in which the oil and gas grant is located. Claimants will do best to find a harmony of support for the contract rights and remedies asserted under both municipal and international law.

In Kazakhstan, as indicated above, the chief threat is that municipal law would allow a change in tax or regulatory legislation to override a contract provision on fiscal or regulatory issues. However, notwithstanding that the Republic could offer sound arguments to the contrary, a reasonable argument can be made that the Civil Code's provisions on breach of contract provide a basis to enforce an oil and gas contract even if tax and regulatory laws provide a specific rule. Similarly, the Republic's contract violations normally run against the grain of Kazakhstan's stabilisation legislation despite its weakening.

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will remain a rich battlefield for theoretical discourse because divergent interests underlie the debate. The state's sovereign right to demand adherence to legislation carries special political force when joined with natural resources. Nonetheless, the degree to which foreign companies will prove willing to invest in emerging market countries hinges on the extent to which they perceive that stability exists for their long-term projects. From a legal standpoint, the right of a state to legislate away the very economic terms of a commercial agreement eviscerates the contractual nature of the instrument and jeopardises the viability of contract as a legitimate domain through which states and foreign companies can work together to their mutual benefit.

The coming years will be very interesting times in Kazakhstan for foreign oil and gas investors. It is to be hoped that the Republic will honour existing subsoil contracts and provide a stable regulatory framework that will give confidence to foreign companies to invest in Kazakhstan. In view of the events of the last few years as described in this article, the future will require vigilance and creative legal thinking.