

Beyond “Resource Nationalism”

Implications of State Ownership in Kazakhstan’s Petroleum Sector

PONARS Eurasia Policy Memo No. 98

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April 2010

Analysts have likened the growing direct state role in Kazakhstan’s petroleum sector since 2002 to a form of “resource nationalism” that is part of a global trend precipitated by high oil prices. This interpretation has obvious appeal, both in light of earlier periods in which waves of nationalization coincided with oil price booms and the recent so-called “re-nationalizations” in Bolivia, Venezuela, and elsewhere. However, it is misguided for two reasons.

First, it fails both to distinguish among forms of ownership structure over the petroleum sector and to delineate the respective roles of host governments and foreign oil companies under each of these different forms. In the early 1990s, Kazakhstan adopted foreign private ownership over its petroleum sector by selling off its assets to multinational oil and gas companies primarily via concessionary contracts, the terms of which were already being forcibly “renegotiated” by the late 1990s. When it ratified a new production sharing agreement law in 2005 requiring the national oil and gas company KazMunaiGaz (KMG), created in 2002, to hold a 50 percent stake in all new deals, Kazakhstan adopted state ownership without control by retaining a large role for direct foreign investment in its petroleum sector.

Second, it ignores the underlying domestic factors that have contributed to these changes in Kazakhstan’s petroleum sector. As is widely recognized, the political opposition in Kazakhstan reached its peak in 2001 with the emergence of the Democratic Choice of Kazakhstan. Since then, President Nursultan Nazarbaev has faced few challenges to his continued rule, in part because he has been able to utilize

patronage to co-opt the opposition with the help of state resources, a process that was helped by the acceleration of profits from the petroleum sector in the early 2000s. Viewed in this context, the change to state ownership should be understood as a strategy to consolidate political power – not merely because it provides the state with access to a greater portion of petroleum rents but also because it increases its discretionary control over this type of income.

Thus, the bad news is that state ownership is a conscious (and, thus far, effective) strategy to fuel the consolidation of authoritarian rule in Kazakhstan. There is also good news, however. The fact that Western (particularly U.S.) oil companies continue to dominate what are currently the country's most significant fields (in terms of size of reserves and production) and have not been completely shut out of developing future fields means that they still have the *potential* to play a much more positive role in Kazakhstan by embracing corporate social responsibility (CSR). What is needed, then, is more, not less, direct foreign investment in Kazakhstan's petroleum sector – but of the right kind. Both because the specter of "resource nationalism" has made many Western oil companies wary about existing and future investments in Kazakhstan, and U.S. oil companies have not yet opted to play an active role in promoting pro-CSR initiatives, this will require renewed U.S. government financial and moral support.

Not all "Nationalizations" are Created Equal

The use of the term "resource nationalism" to describe what has been occurring in Kazakhstan obscures three distinct ways in which a host government can unilaterally change (or seek to change) its pre-existing contractual relations with foreign oil companies: 1) forced "renegotiation" of the terms of existing contracts; 2) nationalization of current or future shares in development projects via state purchase or partnership; and 3) expropriation of assets sold to foreign oil companies via confiscation -- usually without adequate compensation. Kazakhstan has been routinely exercising the first option since at least the late 1990s. It has actively pursued the second option since the end of 2004. However, it has not yet engaged in the third tactic (expropriation) and seems unlikely to be headed in that direction. Yet it is this option that is most closely (and accurately) associated with the wave of "resource nationalism" that swept across petroleum-rich states in the Middle East, North Africa, and Latin America in the 1960s and 1970s.

Forced contract "renegotiation" is consistent with Raymond Vernon's (1971) theory of the "obsolescing bargain," whereby the host government takes advantage of an increase in its relative bargaining power once foreign investors have already made a substantial initial investment that cannot be recovered (i.e., "sunk costs") to extract a greater share of the proceeds from petroleum development. While most analysts point to 2002 as the crucial year in which the Kazakhstani government began to exert greater influence over the petroleum sector via the creation of KMG, foreign oil companies operating in the country have long complained of the state's tendency to renege on contractual terms.

During the late 1990s, for example, foreign oil companies were routinely forced to pay VAT "due to budgetary shortfalls" despite the fact that their contracts made them

exempt. Foreign oil companies have also been continuously subjected to new legislation concerning export restrictions and taxation despite the explicit stability guarantees included in their contracts. In 2000, for example, Kazakhstan's government announced that it would undertake "a compulsory review of all contracts" to determine whether they were in compliance with the country's new tax code. At the regional level, state intervention has taken an even more direct form. For example, local authorities have often imposed work stoppages in order to extract extra-contractual payments to supplement regional budgets, finance local infrastructure projects, or contribute to their discretionary funds.

What occurred at the end of 2004 was not merely part of the trend toward increasing state influence in the petroleum sector via KMG and the obsolescing bargain. Had it occurred in isolation, Kazakhstan's assertion of the state's right to first refusal when British Gas sought to sell its share in the OKIOC (Offshore Kazakhstan International Operating Company) consortium developing the Kashagan field could certainly be viewed in this light (the move was retroactively codified in an amendment to the Law on Subsurface Use). The July 2005 Law on Production-Sharing Agreements (PSAs), however, signals a clear shift in strategy from forced contract "renegotiation" to nationalization. More specifically, it amounts to a conscious change in ownership structure from foreign private ownership to state ownership without control, as defined below.

Two components of the law are crucial here. The first is that it makes PSAs the preferred contractual form going forward. Up to now, the majority of oil and gas production in Kazakhstan has taken place in fields that are under concessionary contracts. This includes Tengiz, one of three largest fields in terms of reserves and the single largest producing field (approximately 35 percent of total current production), as well as several older, smaller fields (Aktobe, Emba, Kumkol, and Uzen) that have much smaller reserves but together account for approximately 50 percent of current production. The other three largest fields (in terms of proven or projected reserves) – Karachaganak, Kashagan, and Kurmangazy – are already under PSAs. All future contracts – notably, those that involve offshore fields in the Caspian Sea (like Kashagan and Kurmangazy), where most of the country's future production is expected to lie – will also be negotiated as PSAs. The second is that it requires that KMG own a *minimum* of half the shares (50 percent) in all new (i.e., offshore) projects. Combined with the state's newly enshrined (and expanded) right of first refusal that facilitates its ability to acquire majority stakes in existing projects (onshore and offshore), the national oil and gas company is now poised to become the majority owner in the country's petroleum sector.

Just as it is important to distinguish between renegeing on contractual terms and requiring the national oil and gas company (NOC) to be *at least* an equal partner in all new contracts, there is also an important distinction to be made between state ownership with control and without. On the one hand, because the state has designated itself as the rightful owner of what is actually the entire nation's property, under both forms of ownership structure we should expect an expanded role for the NOC, much less transparency, and higher social expectations regarding both the extraction and allocation of proceeds generated from the petroleum sector.

Forms of Ownership Structure

- *State ownership with control.* The state must own the rights to develop the majority of mineral deposits and hold the majority of shares (50 percent or more) in the mineral sector. Foreign involvement in the mineral sector is limited either to participating in contracts that restrict their managerial and operational control, such as carried-interest or joint ventures (JVs), or to operating as service subcontractors.
- *State ownership without control.* The state must own the rights to develop the majority of mineral deposits and hold the majority of shares (50 percent or more) in the mineral sector. Foreign investors can participate through more permissive contracts, such as PSAs, which grant them significant managerial and operational control.
- *Private domestic ownership.* Private domestic companies can own the rights to develop the majority of mineral deposits and hold the majority of shares (50 percent or more) in the mineral sector.
- *Private foreign ownership.* Private foreign companies can own the rights to develop the majority of mineral deposits and hold the majority of shares (50 percent or more) in the mineral sector via concessionary contracts.

Indeed, in the few short years since Kazakhstan adopted state ownership without control we have already witnessed these trends. For example, KMG is required not only to supply household and industrial consumers with subsidized fuel throughout the country but also to sell petroleum products to the agricultural sector at well below market price. KMG is also expected to finance cultural events and construction projects that provide highly visible and short-term benefits to the general public. At the same time, the Kazakhstani government has altered the rules governing its Natural Resource Fund in order to utilize the funds to pay for an ambitious state-driven development program that it launched in 2006 without specifying how the money will actually be spent. On the other hand, the key difference between state ownership with and without control is that under the latter, foreign oil companies can still play a significant role in developing the petroleum sector. As I will argue below, under certain conditions, this can mitigate the negative effects described above.

The Fuel for Consolidating Power

Blurring these distinctions also serves to privilege the role of international (over domestic) factors in explaining “resource nationalism.” Analysts have commonly described what has occurred in Kazakhstan as part of a global trend in response to booming oil prices, which automatically shifts the bargaining power away from foreign oil companies and toward the host government. The empirical evidence, however, suggests otherwise.

First of all, the number of petroleum rich countries in the developing world that have retained private foreign ownership — Kazakhstan’s previous ownership structure

– since international oil prices began to rise rapidly in the early 2000s is quite high (about two-thirds of the total). In fact, the number of countries adopting this form of ownership structure has been increasing since 1990; whereas at the beginning of the 1990s there were 10 such countries (out of 45, or 22 percent), by 2005 there were 17 (out of 47, or 36 percent). At least two such countries (Algeria and Indonesia) actually adopted private foreign ownership, in lieu of state ownership without control, during the oil boom. Secondly, several of the classic cases cited as evidence of this global trend either amounted to new legislation that explicitly violated (but did not end) existing contracts with foreign oil companies (e.g., Bolivia) or reasserted the state's primary ownership rights vis-à-vis foreign oil companies (e.g., Venezuela). Finally, the Kazakhstani government was already in a relatively strong bargaining position vis-à-vis foreign oil companies due to the latter's inability to thwart continuous contractual violations, for example by forming a united front. Despite forming organizations such as the Kazakhstan Petroleum Association (KPA) in the late 1990s to represent their collective interests, individual oil companies made bilateral "backroom" deals with the Kazakhstani government that undermined these efforts.

In Kazakhstan, domestic factors played the key role in the government's decision to adopt a new ownership structure in 2005. I am not referring to the nationalist sentiments of the regime or the population, since it is well known that both were just as strong in the early 1990s, if not stronger than they are now. Nor is the issue of fairness relevant here, since by industry standards the contracts signed in the 1990s set reasonable terms considering the risks involved. Rather, the primary motivation for adopting state ownership without control was regime consolidation.

Whereas in the early 1990s the Kazakhstani government adopted private foreign ownership in order to generate revenue quickly (e.g., from royalty payments) so as to counter opposition forces that threatened Nazarbaev's continued rule, by the early 2000s both the need for quick cash and the threat of political opposition had abated. The state's budgetary revenue from petroleum development alone (i.e., excluding bonuses, privatization receipts, and other exceptional payments) began to rapidly accelerate as of 2000; it nearly quadrupled from \$158 million in 1999 to \$604 million in 2000, and then more than doubled the next year to \$1.43 billion. In addition, any viable opposition had been virtually eliminated by this time. Some of the reasons for its debilitated condition consist of the failure of opposition leaders to mobilize a sustained constituency and their relatively limited resources. At least equally important, however, is the Nazarbaev regime's increased ability to utilize its coercive capacity and access to patronage to either intimidate or co-opt opposition leaders.

Making Lemonade out of Lemons

The news is not all bad. That adopting state ownership without control is both a conscious and (to date) effective strategy to fuel the consolidation of authoritarianism in Kazakhstan is an unfortunate but hardly unique outcome. In other words, given the dearth of democratic regimes in its neighborhood, it is highly likely that Kazakhstan would have ended up in the same place with or without petroleum wealth. More troubling are the social and economic implications of a petroleum-rich country that lacks any checks on its discretion to extract and spend proceeds from this sector. One of

these, certainly, can come from civil society. However, there is also another potential source – foreign oil companies that are both committed to corporate social responsibility (CSR) and are able to effectively resist the obsolescing bargain. The choice of state ownership without control rather than state ownership with control means that this is still a real possibility.

While there is ample and often justifiable skepticism about the actual impact of CSR, there is also good reason for some optimism about its potential under the two aforementioned conditions – and it comes from within the post-communist world. Consider the experience of Azerbaijan, which adopted and has retained state ownership without control since the early 1990s. In short, because the majority of foreign oil companies operating in the country have not only embraced the principles of CSR but also been able to form a united front against the government, they have improved the prospects for Azerbaijan's oil wealth to actually improve its citizens' lives. There are several areas in which this has occurred, including: 1) raising the level of transparency; 2) contributing to local business development; and 3) involving local communities in the determination and evaluation of socioeconomic development projects.

In the interest of space, I will highlight only the first of these. Relative to Kazakhstan (and most other petroleum-rich countries in the developing world), Azerbaijan has a fairly high degree of transparency over its oil revenues. A major factor has been the leadership of British Petroleum (BP), which has received financial as well as moral support from the British government. As the operator of the Azerbaijan International Operating Company (AIOC), BP has essentially imposed its own preference for disclosing both the terms of its contract and its payments to the government on the other members of the consortium – including SOCAR (the State Oil Company of the Republic of Azerbaijan). Alongside Shell and Statoil, BP has also influenced Azerbaijan's decision to join the Extractive Industries Transparency Initiative (EITI), making it part of the first tranche of petroleum-rich countries to do so and only one of two countries deemed to be in compliance. Conversely, the refusal of TCO (Tengizchevroil, operated jointly by the U.S. company Chevron and now KMG) to join EITI until 2008 is widely considered to have been the chief obstacle to EITI implementation in Kazakhstan.

This publication was made possible by a grant from Carnegie Corporation of New York. The statements made and views expressed are solely the responsibility of the author.