

ARBITRATION V (116/2010)

**IN THE ARBITRATION INSTITUTE OF THE STOCKHOLM
CHAMBER OF COMMERCE AND IN THE MATTER OF ARBITRATION
BETWEEN:**

**ANATOLIE STATI, GABRIEL STATI, ASCOM GROUP S.A., AND TERRA RAF
TRANS TRADING LTD.**

Claimants

- and -

REPUBLIC OF KAZAKHSTAN

Respondent

STATEMENT OF DEFENCE

21 November 2011

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PART 1: INTRODUCTION

1 Introduction

- 1.1 This Statement of Defence is submitted in accordance with Article 24 of the Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce (**the SCC Rules**) and Procedural Order No. 1 dated 12 January 2011 as amended by the Arbitral Tribunal on 22 February and 15 May 2011.
- 1.2 The Respondent (**the Republic**) submits one copy of this Defence to the Secretariat of the SCC and one copy directly to each of the Arbitral Tribunal. A copy of this Defence is also being sent directly to the Claimants via their legal representatives, King and Spalding LLP.
- 1.3 All future written communications relating to this arbitration should be sent to the Republic's legal representatives at the following addresses:

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2 Summary

- 2.1 The Claimants have advanced an opportunistic claim against the Republic based on generalities, exaggerations and inaccuracies in an attempt to “make good” any losses they may have suffered as a result of their own management of their commercial investments.
- 2.2 In the presentation of their claim, a careful analysis will reveal that:
- (a) The Claimants have dealt with jurisdiction in a cursory manner in order to conceal the vagueness of their legal entitlement to protection;
 - (b) In relation to the alleged indirect expropriation and campaign of harassment (which are denied), they have conflated a series of unrelated events in order to paint a negative picture of the potential consequences of investing in Kazakhstan;
 - (c) In relation to the alleged direct expropriation, this is denied. The Republic simply exercised its rights in accordance with Kazakh law and the contracts;
 - (d) The Claimants have overstated both the value of the financial commitment made in Kazakhstan and the value of the relevant assets thus framing their claims in a way which maximises their financial gain if they are successful; and
 - (e) Simultaneously, the Claimants have underplayed their own failures and eventual abandonment of the assets and the technical difficulties they experienced in their opportunistic adventures in Kazakhstan, none of which can be attributed to the Republic.
- 2.3 In reality, the Republic recognises and supports the promotion of investment into Kazakhstan. At the same time, the Republic, as an emerging global energy power, has sought to regulate subsoil use according to its own law, in accordance with international norms, and as permitted by the ECT.
- 2.4 The Claimants have publicised their ill-founded claims widely. The Republic’s willing participation in these proceedings demonstrates the importance the Republic places on correcting such misplaced perception. However, the Republic vigorously denies that the Arbitral Tribunal has jurisdiction to hear the matters before it in relation to the Claimants. Further, the Republic denies the substantive allegations against it in respect of Articles 10 and 13 of the ECT. The Republic also notes the inaccurate and misleading reference to the Republic violating articles 11 and 14 in paragraph 36 of the Statement of Claim (**the SoC**), which the Claimants have provided no support for and failed to make any further reference to when developing its factual and legal arguments.

3 Procedural matters

- 3.1 The Republic has been ambushed by these proceedings. Leaving aside the serious jurisdictional problems with the Claimants' case (which are dealt with in detail below), the procedural timetable set out is unduly short for the issues at hand. Moreover, the timetable is inherently biased in favour of the Claimants. As a result, the Republic has been forced to develop its case in an unduly short time. As a matter of fact, the Republic has been (and, it is likely, will continue to be) prejudiced by the short procedural timetable established by PO1.
- 3.2 The Republic intends to deal with these issues separately by way of application to the Arbitral Tribunal.

4 Background

A. Overview on Republic's Stance on Investments

- 4.1 Natural hydrocarbon resources are one of the principal assets of the Republic. According to the data of U.S. Energy Information Administration (EIA),¹ within the next ten years Kazakhstan will be in a position to join the top five world oil producers since Kazakhstan holds 30 billion barrels of proved oil reserves and 85 trillion cubic feet of gas reserves.²
- 4.2 Since independence in the early 90s the Republic has sought to attract foreign technical and financial investment to assist the Republic in exploiting these resources, with a view to developing its economy and ultimately to benefiting its people. Accordingly, Kazakhstan secures and supports a favourable investment climate which is recognized internationally. Each year Kazakhstan steadily goes up in the rating 'Doing Business according to the information of World Bank' (2007 – 80th place, 2008 – 70th place, 2009 - 63rd place, 2010 – 59th place).³ This year Kazakhstan has joined 50 countries with the most favourable business climate taking the 47th position.⁴
- 4.3 According to the Report of the World Bank on Doing Business 2012, the investment climate in Kazakhstan has improved significantly in terms of certain figures. In the category of investment protection, Kazakhstan occupies the 10th place in the world due to introduced improvements in the area of regulation of transaction approval among the interested parties as well as due to simplification of procedures for holding the directors liable in case of entering into transactions which do harm to all the parties concerned. The legislation of Kazakhstan has fixed low interest rates and simplified the taxation system, thus ranking 13th place in terms of the payment of

¹ Energy Information Administration of the US Department of Energy

² Retrieved from: <http://www.eia.gov/countries/cab.cfm?fips=KZ>, last visited on: 01.11.2011 (**Exhibit R-108**)

³ Exhibit R-110

⁴ Retrieved from: <http://www.marketwatch.com/story/kazakhstan-enters-top-fifty-world-economies-for-doing-business-continues-march-up-world-banks-rankings-2011-10-20>, last visited on: 01.11.2011 (**Exhibit R-109**)

taxes. Kazakhstan also ranks 29th in the category of property registration and 27th in terms of enforcement of contracts. Moreover, Kazakhstan has adopted the IPDO⁵. Meeting the criteria and compliance with the principles of the IPDO has already resulted in a significant improvement of the legislative base in the mineral resources sector.⁶

- 4.4 The government of the Republic is the sovereign body with responsibility for managing this process of investment and exploitation. The Republic understands the speculative nature of investment in the natural resources sector and the fact that, having taken on considerable risks in prospecting reserves and establishing infrastructure to enable their exploitation, the investor is entitled to a return on its investment which is commensurate with the burden of risk which it shouldered at the outset of the process.
- 4.5 However, the Republic expects and is entitled to expect that investors will also recognise the underlying purpose of the invitation which the Republic has extended to them. Investors should therefore conduct themselves in a way which enables a proper balance to be struck between the legitimate expectations of the investor of a reasonable return on its investment and the legitimate expectation of the Republic that investments will be made and managed in a lawful manner and in a manner which assists the development of the national economy and enhances the financial and technical wealth of the Kazakh people as a whole.
- 4.6 In the vast majority of cases it has been possible to maintain the balance of rights with boundaries acceptable to both the Republic and investors. Unfortunately, a minority of investors have elected to operate without regard to the Republic's legitimate interests. In these cases, to prevent the value of the Republic's valuable and finite assets being exploited with little or no return for the Republic and its people, the Republic has been obliged to exercise rights under domestic laws to restrain these investors, and preserve the Republic's assets for future legitimate exploitation by another investor or the Republic itself.
- 4.7 The Republic's duty is to further the interests of its people. However, it recognises that those interests are best served by working collaboratively with international investors to exploit the Republic's natural resources to mutual advantage. The Republic recognises this will only be possible if investors have certainty as to the security of their investments in the Republic's territory. The Republic is therefore acutely aware of the potential negative effect on investor confidence of the steps which the Republic was ultimately obliged to take in respect of KPM and TNG. The Republic notes that the Claimants wasted little time, once the Republic had acted to restrain their activities, in seeking to undermine investor confidence by a series of negative press and internet articles.

⁵ Extractive Industries Transparency Initiative is a world standard contributing to securing the transparency of revenues from the oil, gas and mining industries. Retrieved from: www.eiti.org (**Exhibit R-111**)

⁶ VI Eurasian Forum KazEnergy, Astana, 5 October 2011 (**Exhibit R-112**)

- 4.8 Notwithstanding the potential negative effects on investor confidence, in this instance, the Republic remains resolutely of the view that it acted properly and within the bounds of its powers under domestic and international law, to protect the interests of its people. The Republic views this arbitration as a positive process which will allow its actions to be vindicated by an independent and properly informed Arbitral Tribunal. That process includes consideration of whether the Claimants are entitled to protection under the ECT and whether any such protection is to be invoked using the processes that the Claimants have engaged.

B. The ECT's object and purpose

Right to regulate natural resources and public welfare

- 4.9 Of course, the rights of investors must be balanced against the rights of the State's hosting the investments. Every State has the right to regulate its natural resources. The ECT recognised this at article 18 which provides as follows:

"(1) The Contracting Parties recognize state sovereignty and sovereign rights over energy resources. They reaffirm that these must be exercised in accordance with and subject to the rules of international law. (2) Without affecting the objectives of promoting access to energy resources, and exploration and development thereof on a commercial basis, the Treaty shall in no way prejudice the rules in Contracting Parties governing the system of property ownership of energy resources."

- 4.10 The ECT is intended to engender reciprocal obligations between Contracting States and their investors. This is recognised in the Introduction to the ECT which states:

"The fundamental objective of the [ECT's] provisions on investment issues is to ensure the creation of a 'level playing field' for energy sector investments throughout the Charter's constituency, with the aim of reducing to a minimum the non-commercial risks associated with energy-sector investments."

- 4.11 It is clear therefore that the ECT requires a balance of rights, which inherently involves consideration of the rights and expectations of Contracting States as well as those of investors.
- 4.12 As will be shown, the failures of the Claimants to provide any meaningful return to the Republic for their alleged investments (in particular in relation to the payment of taxes and the failure to contribute to the technological information exchange key to development) not only attracted legal consequences in the Republic, but importantly casts doubts on the Claimants' suitability to benefit from investment protection at the international level.

PART 2: JURISDICTION

5 No Jurisdiction and inadmissibility of claims

- 5.1 The Claimants' claim is unfounded and ill-conceived. This is most obviously seen in its shaky assertions regarding the jurisdiction of the Arbitral Tribunal to hear this case.

Importance of Jurisdiction

- 5.2 The question of whether jurisdiction is established goes to the heart of any arbitration, let alone investment treaty arbitration. In any arbitration, the importance of the consent of each party is pivotal to establishing that a party has willingly agreed to forego the normal route of dispute resolution under which a dispute might be heard (i.e. the courts) for a specially agreed party framed forum of dispute resolution.
- 5.3 This is all more the case in investor-state arbitration. In investor-state arbitration under a multilateral treaty such as the ECT, the State offers to arbitrate to a potentially huge number of investors who may seek redress. The limits of the State's consent to arbitrate need to be carefully considered in order to ensure that only those investors who qualify for protection under the terms of the treaty can seek redress.
- 5.4 Indeed, a significant number of cases won by States in international investment arbitrations are won on the basis that the Arbitral Tribunal lacks jurisdiction to hear the claims of the alleged investor. Success on jurisdiction arguments is decisive:

“Objections to the jurisdiction, if successful, stop all proceedings in the case, since they strike at the competence of the Arbitral Tribunal to give rulings as to the merits or admissibility of the claim...”⁷

Objective legal test to be applied

- 5.5 The arbitral tribunal is the “*gatekeeper*”⁸ of the correct and proper application of jurisdiction and the test to be applied as to whether jurisdiction arises is an objective one, not a prima facie one. Under the principle of Kompetenz-Kompetenz recognised internationally in international commercial arbitration, the arbitral tribunal has a right and a responsibility to consider its own jurisdiction to hear a claim put before it.⁹

⁷ I. Brownlie, *Principles of Public International Law* (Oxford University Press, 7th edn, 2008) page 475 (**Exhibit R-170**)

⁸ Z. Douglas, *The International Law of Investment Claims*, Oxford University Press (2009), paragraph 503 (**Exhibit R-61**)

⁹ A. Tweedale, K. Tweedale, *Arbitration of Commercial Disputes*, Oxford University Press, (2007), section 5.72. (**Exhibit R-157**)

- 5.6 The Claimants have produced a vast Statement of Claim dealing with the allegations against the Republic. Yet the Claimants' treatment of this important aspect of the arbitration is dealt with in little more than 5 pages of the 183 page Statement of Claim.
- 5.7 The Republic will demonstrate that the Claimants' jurisdictional submissions studiously ignore specificities in order to mask the fact that none of the Claimants have established, either separately or together, an entitlement to protection under the ECT.

Burden of Proof

- 5.8 As the Arbitral Tribunal is aware, there are established international legal rules on the burden of proof.
- 5.9 The first rule is that the burden of proof lies on he who asserts. Each party must prove the facts to which it refers¹⁰. This principle is recognised in the decisions reached in *Tradex v. Albania*¹¹ and *MECSH v. Egypt*¹² and is "a general principle of international procedure - and probably also of virtually all national civil procedural laws." Accordingly, it is incumbent on the Claimants to demonstrate that the Arbitral Tribunal has jurisdiction to consider the dispute as set out in cases such as the *Case Concerning Oil Platforms (Islamic Republic of Iran v. United States of America)*.¹³
- 5.10 Second, the following rule is applicable to international law: "*Party having the burden of proof must not only bring evidence in support of his allegations, but must also convince the Tribunal of their truth*".¹⁴
- 5.11 The third principle is the rule that "*the international liability of the state cannot be presumed. The party making a statement about a violation of international law that represents the basis of an international liability bears burden of proving such an assertion*".¹⁵
- 5.12 These rules form an international legal standard for the burden of proof. In support of this standard, tribunal in the decision in the case of *Feldman v. Mexico* has upheld the statement of the international law standard, as stated by the Appellate Body of the WTO: "... various international tribunals, including the International Court of Justice, have generally and consistently accepted and applied the rule that the party who asserts a fact, whether the claimant or respondent, is responsible for providing proof thereof... If that party adduces evidence

¹⁰ "Each party has the burden of proving the facts upon which it relies" (See the award in case *Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/00/5), **Exhibit R-42** para 110)

¹¹ See Award in the case *Tradex Hellas S.A. v. Republic of Albania* (ICSID Case No. ARB/94/2), **Exhibit R-43** para 73 and 74

¹² See Award in the case *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt* (ICSID Case No. ARB/99/6), **Exhibit C-228** para 89

¹³ 1996 ICJ Reports 803, 16 (**Exhibit R-188**)

¹⁴ See Award in the case *Asian Agricultural Products Limited v. Democratic Socialist Republic of Sri Lanka* (ICSID Case No. ARB/87/3), **Exhibit C-255** para 56 and 64

¹⁵ *Ibid.*

*sufficient to raise a presumption that what is claimed is true, the burden then shifts to the other party, who will fail unless it adduces sufficient evidence to rebut the presumption*¹⁶.

- 5.13 As to the standard required, the Claimants are not simply entitled to *allege* that the Arbitral Tribunal has the necessary jurisdiction to hear the dispute, but must adequately prove and evidence the relevant facts on which they rely so that jurisdiction may be perceived to exist “*by a reasonable preponderance of the evidence*”¹⁷. Therefore, where the respondent has made well-founded jurisdictional objections, casting reasonable doubt as to the jurisdiction of the arbitral tribunal, it is important that the claimant is put to proof regarding the necessary evidence and information that the arbitral tribunal has the requisite jurisdiction.¹⁸
- 5.14 Where the lower, *prima facie*, standard has been applied¹⁹ it is submitted that this is generally only justified where urgent relief is required, as once jurisdiction is upheld, there is no procedural imperative to reconsider the questions.²⁰
- 5.15 As set out in detail below, the burden of proof (on any standard) has not been discharged by the Claimants in this case.

Minimum Jurisdictional Standards

- 5.16 As the Claimants note, the relevant ECT test to establish their entitlement to benefit from the protections is set out in article 26. More specifically, the relevant jurisdictional requirements are set out in articles 26(1) and 26(4)(c). The applicable law is set out in 26(6) and include “*applicable rules and principles of international law.*”
- 5.17 In addition, the Claimants must establish how the Stockholm Chamber of Commerce (and any arbitral tribunal constituted under its auspices) has been granted jurisdiction to hear this dispute. The Claimants have failed on both counts.
- 5.18 The Claimants allege at paragraph 26 of the Statement of Claim that all the requirements have been met. This is denied. This section will demonstrate that no jurisdiction has been established on the following bases:
- (a) No arbitration agreement;

¹⁶ Award in the case Marvin Feldman v. Mexico (case No ARB (AF)/99/1 (**Exhibit C-283**) para 177

¹⁷ Waste Management v. The United Mexican States, ICSID Case No. ARB/98/2, Dissenting Opinion, June 2, 2000, at paragraph 9 as cited in Arbitration Under International Investment Agreements - A Guide to the Key Issues edited by Katia Yannaca-Small, OUP, 2010, page 275 (**Exhibit R-174**)

¹⁸ CCL v. Republic of Kazakhstan, SCC Case No. 122/2001, Jurisdictional Award (2003) as cited in Arbitration Under International Investment Agreements - A Guide to the Key Issues edited by Katia Yannaca-Small, OUP, 2010, page 275 (**Exhibit R-174**).

¹⁹ For example, Impregilo S.p.A. v. Islamic Republic of Pakistan ICSID Case No. ARB/03/3, Decision on Jurisdiction, April 22, 2005, paragraph 79 and Pan American Energy, LCC, et al. v. The Argentine Republic, ICSID Case No. ARB/03/13, Decision on Preliminary Objections, July 27, 2006, paragraph 50 as discussed in Arbitration Under International Investment Agreements - A Guide to the Key Issues edited by Katia Yannaca-Small, OUP, 2010, page 273-274 (**Exhibit R-174**)

²⁰ The International Law of Investment Claims by Zachary Douglas, Cambridge University Press, 2009, page 274 (**Exhibit R-61**)

- (b) No consent;
- (c) No jurisdiction *rationae personae*; and
- (d) No jurisdiction *rationae materiae*.

6 No arbitration agreement since there has been an improper reference to the Swedish Chamber of Commerce

- 6.1 In summary, the Russian text of Article 26(4)(c) of the ECT²¹ refers to the Arbitration Institute of the international chamber of commerce in Stockholm as the arbitration body to resolve investment disputes as per the ECT, rather than the SCC.
- 6.2 Accordingly, the reference to the SCC is improper and therefore the Arbitral Tribunal should decline jurisdiction.
- 6.3 Furthermore, the arbitration agreement is void since the agreement violates the principle of sovereign equality of States.

The arbitration agreement

- 6.4 The English language text of Article 26(4)(c)²² of the ECT provides that disputes between the Investor and the Host State may be submitted for consideration to:
- (a) (i) *"The International Centre for Settlement of Investment Disputes, established pursuant to the Convention on the Settlement of Investment Disputes between States and Nationals of other States opened for signature at Washington, 18 March 1965 (hereinafter referred to as "the ICSID Convention")²³, if the Contracting Party of the investor and the Contracting Party party to the dispute are both parties to the ICSID Convention; or*
 - (ii) *The International Centre for Settlement of Investment Disputes established pursuant to the Convention referred to in sub-paragraph (a) (i), under the rules governing the Additional Facility for the Administration of Proceedings by the Secretariat of the Centre (hereinafter referred to as "the Additional Facility Rules"²⁴), if the Contracting Party of the Investor or the Contracting Party to the dispute, but not both, is a party to the ICSID Convention;*

²¹ Exhibit R-1

²² Exhibit C-1

²³ Exhibit R-72

²⁴ Exhibit R-73

- (b) *a sole arbitrator or ad hoc arbitration tribunal established under the Arbitration Rules of the United Nations Commission on International Trade Law (hereinafter referred to as "UNCITRAL"²⁵); or*
- (c) *an arbitral proceeding under the Arbitration Institute of the Stockholm Chamber of Commerce".*

- 6.5 However, Article 26(4) of the ECT in the Russian language is quite different.
- 6.6 The Russian version of Article 26(4)(c) states that an investor may submit the dispute "на арбитражное рассмотрение при Арбитражном институте международной торговой палаты в Стокгольме" ("to an arbitral proceeding under the Arbitration institute of the international chamber of commerce in Stockholm").²⁶
- 6.7 The fact that the word "Arbitration" is written with a capital "A" emphasizes that it does not simply refer to an arbitration institute but to a particular arbitration tribunal - in this case, the arbitration institute of the international chamber of commerce (**Exhibit R-75**).²⁷
- 6.8 Article 50 of the ECT states that each of the 6 language texts of the ECT (English, French, German, Italian, Russian and Spanish) are equally authentic. This is consistent with Article 33 of the Vienna Convention on the Law of Treaties, 1969²⁸ which provides that when a treaty has been authenticated in several languages, the text is equally authoritative in each language. Therefore, the Russian version of the ECT is authentic.
- 6.9 At best, the clause is ambiguous as to its meaning. There are several alternative meanings:
- (a) The clause could mean that disputes are to be referred to the International Court of Arbitration of the International Chamber of Commerce in Stockholm and that the words "Arbitration Institute" should be interpreted to mean the International Court of Arbitration;
 - (b) Another possible interpretation is that the clause is meant to refer to the Arbitration Institute of the Stockholm Chamber of Commerce i.e. that the word "international" should be replaced with "Stockholm".
- 6.10 The first is plausible not least because there is, of course, a court of arbitration of the International Chamber of Commerce in Stockholm. This conclusion is also justified in the report prepared by L. Yu. Ivanov²⁹. The second reading of the clause has the advantage that it is

²⁵ Exhibit R-74

²⁶ Exhibit R-62

²⁷ Report by L. Yu. Ivanov, a consultant of the V. V. Vinogradov Institute of the Russian Language of the Russian Academy of Sciences) (**Exhibit R-75**).

²⁸ Exhibit C-203

²⁹ Report by L. Yu. Ivanov, a consultant of the V. V. Vinogradov Institute of the Russian Language of the Russian Academy of Sciences) (**Exhibit R-75**).

consistent with the text of Article 26(4)(c) of the ECT and of all the other authentic texts, namely: in English, Spanish, Italian, German and French but is, the Republic asserts, incorrect. While it may be easier to conclude that the Russian text concurs with the other texts, this is a conclusion that could only be reached without conducting a careful analysis. As is set out below, in the Republic's submission, this is wrong.

- 6.11 The key expressions for consideration and analysis by the Tribunal are expressions "*under the Arbitration institute*", and "*in Stockholm*", which are set out below.

Analysis of the expression "under the Arbitration institute"

- 6.12 In international practice, two kinds of arbitration courts are common: "one-off" or ad hoc courts and permanent arbitration courts/arbitration institutes.
- 6.13 An ad hoc arbitration court is established by the parties expressly in order to consider a particular dispute. The parties themselves define the procedure of setting up an arbitral tribunal and can agree the rules of the proceedings.
- 6.14 By contrast, permanent arbitration courts are established under various organizations, usually under chambers or trade and commerce. Tribunals constituted under such permanent courts do not consider cases themselves but organize their consideration, by arbitral tribunals created with their assistance (they carry out the general administration of the proceedings).
- 6.15 Permanent arbitration courts have their own idiosyncratic rules for proceedings as well as a list of arbitrators. Permanent arbitration centres are also called in Russian "институционный" (institute) or "институциональный" (institutional) arbitration. They are also called "арбитражные институты" (arbitration institutes).
- 6.16 The term "институт" in Russian may be used to denote any institution, and it is equivalent to the English "institution". The term "арбитражный институт" (arbitration institute) is commonly used in the Russian Federation and in official documents including federal laws to denote various arbitration institutions.
- 6.17 So, for example, in the Rules of the Chamber of Trade and Commerce of the Russian Federation (**Exhibit R-76**), in particular, it is stated as follows:

"Chapter 9. Arbitration institutes ...

...

Chapter 51. Under the Chamber of Trade and Commerce of Russia there are:

International Commercial Arbitration Court

Marine Arbitration Commission

Arbitration Court for Settlement of Economic Disputes

Sports Arbitration

Panel of Mediators for conciliation procedures and other specialized bodies".

- 6.18 Therefore, in these rules, the International Commercial Arbitration Court under the Chamber of Trade and Commerce of Russia is referred to as an “arbitration institute”.
- 6.19 Further, the term "арбитражные институты" (arbitration institutes) is also used in the legislation of the Russian Federation when it refers to settlement of investment disputes (i.e. disputes between an investor and a State). Accordingly, the Federal Law of the Russian Federation dated 30 December 1995 No. 225-FZ "On agreements on division of the production"³⁰ contains the following provision:
- "Article 22. Settlement of disputes*
- Disputes between the State and an investor related to the fulfilment, termination, and invalidity of agreements are to be settled in accordance with the conditions of the agreement in the court, or arbitration court (including international arbitration institutes)".*
- 6.20 By way of another example, a widely known international organisation in Russia is called the "Международная федерация коммерческих арбитражных институтов (МФКАИ)" (International Federation of Commercial Arbitration Institutions (IFCAI)). The main commercial arbitration institutes are part of this organisation including the International Court of Arbitration of the ICC (**Exhibit R-78**).
- 6.21 Therefore, in Russian, and in accordance with Russian practice, the International Court of Arbitration of the ICC (being a member of the International Federation of Commercial Arbitration Institutions) is considered to be an arbitration institute. By contracts, in the English language, the ICC is referred to as an “institution”.
- 6.22 Therefore the expression "при арбитражном институте" (under the “Arbitration” institute) means, in Russian, that the dispute should be considered by an arbitration tribunal acting under the framework of a permanent arbitration centre.
- 6.23 Moreover, where a capitalised “A” is used, this means that that the parties have in mind a particular arbitration institute.

³⁰ In the given case it goes about the Federal Law of the Russian Federation dated 30 December 1995 No. 225-FZ "On agreements on division of the production" in the version of 19 May 2010 (**Exhibit R-77**)

Analysis of the expression "в Стокгольме" ("in Stockholm").

- 6.24 It is important that the meaning of each word used in international treaties is given due consideration, therefore it is important to understand what the expression "в Стокгольме" ("in Stockholm") means.
- 6.25 Based on Article 26(4)(c) of the ECT, disputes between an investor and a host State may be submitted *"на арбитражное рассмотрение при Арбитражном институте международной торговой палаты в Стокгольме"* ("to arbitral proceedings under the Arbitration institute of the international chamber of commerce in Stockholm")³¹.
- 6.26 From the point of view of the Russian language, the expression "в Стокгольме" ("in Stockholm") may refer to the expression "на арбитражное рассмотрение" ("to an arbitral proceeding") as well as to the expression "при Арбитражном институте Международной торговой палаты" ("under the Arbitration institute of the International Chamber of Commerce"). This is ambiguous.
- 6.27 The English and German texts of Article 26(4)(c) of the ECT do not contain such ambiguity. In each of these texts, the clause makes reference to the Stockholm Chamber of Commerce, not to a chamber of commerce in Stockholm (*"an arbitral proceeding under the Arbitration Institute of the Stockholm Chamber of Commerce"*; *"einem Schiedsverfahren im Rahmen des Instituts für Schiedsverfahren der Stockholmer Handelskammer"*). In all the other authentic versions (Spanish, Italian, and French) there is no ambiguity either as they refer to the Stockholm Chamber of Commerce but not to a chamber of commerce in Stockholm (*"un procedimiento de arbitraje por parte del Instituto de Arbitraje de la Cámara de Comercio de Estocolmo"* - Spanish; *"un procedimento arbitrale de parte dell'Instituto di arbitrato della Camera di commercio di Stoccolma"* - Italian; *"une procédure d'arbitrage sous l'égide de L'Institut d'arbitrage de la Chambre de commerce de Stockholm"* - French).
- 6.28 As the Arbitral Tribunal is well aware, consideration of the exact meaning and scope of the arbitration agreement is common. There are many examples of cases in international arbitration where a thorough analysis of the arbitration agreement is required in order to establish its true meaning. The following cases are pertinent.
- (a) In one of such case, the arbitration clause implied settlement of disputes in the International Commercial Arbitration Court (ICAC) under the Chamber of Trade and Commerce of the Russian Federation under the Arbitration Rules of the International Chamber of Commerce. The claim was submitted to the ICAC, the arbitral tribunal was formed according to the ICAC's rules. In the hearing the respondent stated that the arbitral tribunal was not competent in connection with the fact that it was not formed in accordance with the rules of the ICC and, therefore, in violation of the arbitration

agreement. The arbitral tribunal recognized that it did not have jurisdiction. When studying the text of the contract, the arbitral tribunal found that proceedings were to be held according to the rules of the ICC but the "place" was where the ICAC is located.

The claim was resubmitted to the International Court of Arbitration of the ICC, and hearings in the case were held in the premises of the ICAC under the Chamber of Trade and Commerce of the Russian Federation (**Exhibit R-82**).

- (b) The Dresden High Regional Court (the Appellate Court) upheld the decision of the lower instance court in which it was stated that reference to "*the International Chamber of Commerce in Vienna*" in international trade was to be deemed as a reference to the Court of Arbitration of the International Chamber of Commerce. Accordingly, Vienna was the place of arbitration³² (**Exhibit R-83**).
- (c) The Frankfurt am Main High Regional Court (Appellate Court) ruled that the use of the commonly known abbreviation ICC constituted sufficient grounds to consider that the parties intended to subordinate settlement of corresponding disputes to its Rules³³ though the arbitration agreement referred to the Arbitration Rules of the ICC of Brussels (**Exhibit R-84**).
- (d) In one of the cases considered by the Court of Arbitration of the ICC, the final award on which was delivered on 7 June 2011, an arbitration clause was considered which included the words "*the International Chamber of Commerce, Geneva*".

The arbitral tribunal gave the following interpretation of the clause: the parties intended to submit disputes arising between them to the consideration of the Court of Arbitration of the International Chamber of Commerce with the place of proceeding in Geneva (**Exhibit R-85**).

- 6.29 Fouchard, Gaillard, and Goldman in "*On International Commercial Arbitration*"³⁴ highlight that: "*Even in case there is no comma between the appointment of the arbitration institute of the international chamber of commerce and the city stated after that (and this city is not Paris), and even if before the name of the city the preposition "in" is used (instead of a comma), such an arbitration clause means that the parties agreed upon the arbitration court of the International Chamber of Commerce with the place of hearings in the stated city*" (**Exhibit R-86**). This quotation directly refers to the case under consideration. This is directly analogous to the current situation.

³¹ Exhibit R-62

³² Oberlandesgericht (Appellate Court) of Dresden, 05 December 1994, Yearbook Comm. Arb'n XXII (1997), page 266-272, on page 267 (**Exhibit R-83**)

³³ Oberlandesgericht (Appellate Court) of Frankfurt, 24 October 2006, SchiedsVZ 2007, p. 217 and further (**Exhibit R-84**).

³⁴ Fouchard/ Gaillard/Goldman, *On International Commercial Arbitration*, 2003, page 264, paragraph 485, footnote 113 (**Exhibit R-86**)

- 6.30 Therefore, the only correct interpretation of the Russian version of Article 26(4)(c) of the ECT is the following: disputes may be submitted for proceedings in Stockholm, and shall be considered by an arbitral tribunal constituted under the rules of the International Chamber of Commerce.

Interpretation of the arbitration agreement

- 6.31 Article 50 of the ECT provides as follows:

*"In witness whereof the undersigned, being duly authorized to that effect, **have signed this Treaty in English, Spanish, Italian, German, Russian, and French, of which every text is equally authentic**, in one original, which will be deposited with the Government of the Portuguese Republic" (Exhibit C-1).*

- 6.32 Therefore, it is clear that the text of the ECT in Russian is equally authentic as the English text or, for that matter, any other of the authentic texts.

The status of the Russian language in Kazakhstan

- 6.33 It is also clear that, pursuant to Article 7 of the Constitution of the Republic of Kazakhstan (**Exhibit R-91**) that, the Russian language is an official language in Kazakhstan. Article 7 contains the following provision.

"1. The state language in the Republic of Kazakhstan is the Kazakh language.

2. In state organizations and local government bodies the Russian language shall be used along with the Kazakh language."

- 6.34 The authentic text contained in Article 26(4)(c) of the ECT on the arbitration clause in Russian, provides that disputes are to be settled in the International Court of Arbitration of the international chamber of commerce; and that the place of the arbitration proceedings shall be the city of Stockholm, Sweden.
- 6.35 In paragraph 1 of the Supplementary Ruling of the Constitutional Council of the Republic of Kazakhstan of 23 February 2007 №3 the provisions of the cited paragraph 2 Article 7 of the Constitution of the Republic of Kazakhstan are clarified as follows: *"in state organizations and local government bodies the Kazakh and Russian languages will be equally used, irrespective of any circumstances"* (**Exhibit R-92**).
- 6.36 The Republic assumed the obligations under the ECT on the basis of the text in the Russian language (**Exhibit R-3** and **R-4**). Official correspondence within the preparatory process also was carried out in the Russian language (**Exhibit R-5**). A similar conclusion can be made in respect of Moldova (**Exhibit R-6**).

6.37 By contrast, the equally authentic texts of Article 26(4)(c) of the ECT in the other five languages imply the Arbitration Institute of the Stockholm Chamber of Commerce.

6.38 We set out the texts of Article 26(4)(c) in other languages below:

in English:

"an arbitral proceeding under the Arbitration Institute of the Stockholm Chamber of Commerce".

in Spanish:

"un procedimiento de arbitraje por parte del Instituto de Arbitraje de la Camara de Comercio de Estocolmo".

in Italian:

"un procedimento arbitrale de parte dell'Instituto di arbitrato della Camera di commercio di Stoccolma".

in German:

"einem Schiedsverfahren im Rahmen des Instituts für Schiedsverfahren der Stockholmer Handelskammer".

in French:

"une procedure d'arbitrage sous l'egide de L'Institut d'arbitrage de la Chambre de commerce de Stockholm".

Arbitration agreement in the ECT

6.39 It is a trite matter of arbitration law that the parties express their consent to consideration of disputes arising between them in an international commercial deal by negotiating an arbitration clause in their agreement. Such consent is required for the arbitral tribunal to have jurisdiction.

6.40 Consent may be expressed in the form of a public offer to conclude an arbitration agreement included in a bilateral or multilateral international agreement concluded with the investor's State. This offer is addressed to a unlimited group of persons falling under the definition of an investor contained in the international agreement.

6.41 Such an offer of submission of disputes to consideration of the international commercial arbitration is final and irrevocable as long as a corresponding bilateral agreement is valid (at least).

- 6.42 However, the availability of an offer in the international agreement does not finalise the arbitration agreement. Two States concluding an agreement between them cannot force a third party (an investor) to refer to the arbitration in order to settle a dispute. For an arbitration agreement to be concluded, the investor must accept the State's offer. Such a consent (acceptance) may be expressed at any time, and it is expressed in the choice of an arbitration centre and submission of a written statement to it for arbitration.
- 6.43 Therefore, the arbitration agreement between an investor and the State may be concluded in the form:
- (a) By way of an offer of the State contained in international bilateral or multilateral agreements concluded by the State, and acceptance of the investor expressed in submitting a written statement to an arbitration centre of the investor's choice³⁵ (**Exhibit R-93**).
 - (b) Any similar such written agreement of a state or investor to refer disputes between them for consideration by an international commercial arbitration.
- 6.44 Article 26(4)(c) is an offer for arbitration to investors qualifying for protection under the ECT and the Investor accepts the offer by submitting a request for arbitration to the relevant institution or by consenting to the arbitration in an arbitration agreement with the State.

The nullity of arbitration agreements that do not allow for determining the approved arbitration

- 6.45 In certain circumstances, an arbitration agreement is declared void for uncertainty.
- (a) There is no doubt that a commercial agreement in individual cases may be declared void, to which attention is paid in particularly in articles V and IX of the European Convention on foreign-trade arbitration³⁶ (**Exhibit R-94**).
 - (b) Based on Article 26(6) of the ECT a commercial court resolves disputed issues in accordance with "*the applicable rules and principles of international law*". Therefore, international law applies to an arbitration agreement as well having a public and legal character.

³⁵ See, in particular, Piero Bernardini, Investment Arbitration under the ICSID Convention and BITs in: Global Reflections on International Law, Commerce and Dispute Resolution. Liber Amicorum in honour of Robert Brinner. International Chamber of Commerce (ICC) Publishing, 2005, p. 93-98; Investment Arbitration and the Energy Charter Treaty. Edited by Clarisse Ribeiro. JurisNet LLC, 2006, p. 308; Alexander I. Beloglavik. Investment Protection, the law of the European Union and international law. Kiev, Takson. 2010, p.140-141 (**Exhibit R-93**).

³⁶ The European Convention on International Commercial Arbitration was made in Geneva on 21 April 1961 and came into force on 7 January 1964.

- (c) Judicial decisions declare an arbitration agreement as void (non-existent) where, by virtue of differing authentic texts, the clause appears to simultaneously refer to arbitration to different arbitration courts. Based on clause 1 "d" of article 38 of the Statute of the International Court of the UN (**Exhibit R-26**), judicial rulings are considered as auxiliary sources for determining the norms of international law.

6.46 The following examples are pertinent:

- (a) In Russia, the parties agreed that disputes must be considered "*in the Arbitrazh Court under the Chamber of Commerce and Industry in Moscow*". Until 1995,³⁷ both the International Commercial Arbitrazh Court under the Chamber of Industry and Commerce of the Russian Federation (which is located in Moscow and the Arbitrazh Court under the Moscow Chamber of Commerce and Industry (it was also located in Moscow and called the Arbitrazh Court under the Chamber of Commerce and Industry)). Based on the jurisdictional hearing in the case concerning validity of the arbitration agreement, the Moscow Commercial Arbitrazh Court came to the conclusion that "*the arguments of the parties in favour of any given version are just unilateral assumptions and cannot serve as convincing legal grounds for establishing the competency of the Moscow Commercial Arbitrazh Court*" (**Exhibit R-95**).
- (b) The case considered by the Federal Supreme Court of Germany (case III ZR 85/81, ruling dated 2 December 1982 (**Exhibit R-96**)) is another example of this situation.
- (c) The arbitration agreement was concluded in both German and Italian. The German text allowed, with a certain lag time, to make the conclusion that the case should be considered by arbitration court "X" based on the rules of arbitration institute "Y". The Italian text did not have a reference to arbitration institute "X", while the case should have been considered by arbitrazh institute "Y" in accordance with its rules. Reading both the German and the Italian texts, the logical conclusion is that it is possible to refer the case simultaneously to two different arbitration courts. The court came to the conclusion that this arbitration agreement is void for uncertainty.

Arbitration agreement void

6.47 Therefore and by analogy, on the basis that there is a lack of clarity as to whether the arbitration ECT refers to the ICC in Sweden, the SCC or both, the arbitration agreement concluded by the Republic and the Claimants as reflected in Article 26(4)(c) of the ECT, is void.

³⁷ In 1995 it was renamed as the Commercial Arbitrazh under the Moscow Chamber of Industry and Commerce.

No consent to arbitration before the SCC

6.48 In any event, it is beyond doubt that, in these circumstances, the Claimants have entirely failed to consider or explain the inconsistencies between the authentic texts of the ECT and the resulting difficulties in establishing a clear and unequivocal intention of the parties to arbitrate in the SCC. This should be examined closely by the Arbitral Tribunal. Accordingly, even if Article 26(4)(c) is not found to be void, it is clear that an improper reference has been made to the SCC. On any proper reading of Article 26(4)(c) with the benefit of the Russian text, it is clear that the reference to the SCC has been improperly made. In such circumstances, the Arbitral Tribunal has a duty to decline jurisdiction.

The arbitration agreement being void and the pre-emptory norms of common international law (jus cogens norms)

6.49 Pursuant to Article 53 of the 1969 Vienna Convention on the Law of International Treaties (**Exhibit C-203**):

"A treaty is void if, at the time of its conclusion, it conflicts with a pre-emptory norm of general international law. For the purposes of the present Convention, a pre-emptory norm of general international law is a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character."

6.50 Based on the above, States are prohibited from concluding treaties which conflict with pre-emptory norms (or jus cogens norms) of international law.

6.51 Certain jus cogens norms are set out in the Declaration on Principles of International Law concerning Friendly Relations and Cooperation among States in accordance with the Charter of the United Nations dated 24 October 1970 (**Exhibit R-67**). The Declaration provides seven principles of international law which are regarded as a part of the "constitution" for the international community:

- (a) *"The principle that States shall refrain in their international relations from the threat or use of force against the territorial integrity or political independence of any State, or in any other manner inconsistent with the purposes of the United Nations,*
- (b) *The principle that States shall settle their international disputes by peaceful means in such a manner that international peace and security and justice are not endangered,*
- (c) *The duty not to intervene in matters within the domestic jurisdiction of any State, in accordance with the Charter,*

- (d) *The duty of States to co-operate with one another in accordance with the Charter,*
- (e) *The principle of equal rights and self-determination of peoples,*
- (f) ***The principle of sovereign equality of States,***
- (g) *The principle that States shall fulfil in good faith the obligations assumed by them in accordance with the Charter*.³⁸

6.52 Each of the seven principles is essential to the “constitution” and is based on universal values.³⁹ States have voluntarily accepted these principles/norms in their relations with each other. As such, these principles are widely regarded as jus cogens norms of contemporary international law.

6.53 This is supported by the publication “*Imperative Norms in the System of Contemporary International Law*” from the late professor L.I. Shestakov, the former head of the Department of International Law at Lomonosov Moscow State University⁴⁰ (**Exhibit R-102**) which states:

“the principles of international law regarding friendly relations and cooperation of states in accordance with the UN Charter, in other words the principles that are supported in the Declaration of Principles passed at the jubilee session of the General Assembly of the UN on 24 October 1970, are jus cogens norms.”

Principle of sovereign equality

6.54 The sovereign equality of States is one of the key principles set out in the declaration and is therefore a jus cogen norm of international law.

6.55 This is supported by paragraph 1 of Article 2 of the UN Charter (in force from 24 October 1945) (**Exhibit R-28**), which provides that:

“The Organization is based on the principle of the sovereign equality of all its Members”

6.56 The sovereign equality of states is therefore the foundation for modern international relations and is part of the “natural elements”⁴¹ for the existence of States.

6.57 Pursuant to the principle, all States should be considered as legally equal regardless of when they became recognised as States by the international community, the size of its territory or the

³⁸ Exhibit R-67 (emphasis provided)

³⁹ See Wolfgang Graf Vitstum and others. *International law* Infotropik Media, 2011, page 43 (**Exhibit R-101**)

⁴⁰ See L.I. Shestakov. *Imperative Norms in the System of Contemporary International Law*. Publishing House of Moscow State University, 1981. pg. 116. (**Exhibit R-102**)

⁴¹ See Wolfgang Graf Vitstum and others. *International law* Infotropik Media, 2011, page 43 (**Exhibit R-101**)

size of its population. The principle of sovereign equality therefore confirms the principle that "*in the same situation states have equal rights*"⁴². As a result:

- (a) All States should have equal rights when considering their legal position in international legislation and other law; and
- (b) All States are equal when applying the international and legal mechanisms for resolving disputes.

Violation of the principle of sovereign equality in the ECT

- 6.58 As explained above, all of the authentic texts of the ECT except the Russian text allow an investor to commence arbitration proceedings in the Stockholm Chamber of Commerce pursuant to Article 26(4)(c).
- 6.59 The consequence of this is that a Swedish investor could commence proceedings with a Swedish arbitration institute (the SCC) against a foreign state and potentially receive a ruling against that foreign state. This has already occurred in the case of *Nykomb Synergetics Technology Holding AB (Sweden) v. Latvia*⁴³.
- 6.60 This violates the principle of sovereign equality as:
- (a) A Kazakh investor cannot commence proceedings in a Kazakh court or arbitration institute against Sweden, nor can an investor in any other country commence proceedings in a local court or arbitration institute against Sweden;
 - (b) This effectively gives Swedish investors an inequitable right to commence proceedings in a Swedish arbitration institute which is a right that investors in other countries do not have;
- 6.61 Article 26(4)(c) therefore violates the jus cogens norm of sovereign equality of States.

7 No State consent to arbitration as the cooling-off period is not satisfied

- 7.1 Article 26(2) of the ECT provides for a "cooling-off period" of three months between the date upon which a claimant notifies that it has a dispute with a Contracting Party (i.e. a State) and the date upon which it submits that dispute for arbitration, with the intention that that three month period provides a window for amicable resolution.
- 7.2 The requirement for "cooling-off period" was not met by the Claimants. Notwithstanding this, and without prejudice to the Republic's objections on these grounds, the parties agreed and the

⁴² See Wolfgang Graf Vitstum and others. International law Infotropik Media, 2011, page 44 (**Exhibit R-101**)

Arbitral Tribunal awarded by consent on 22 February 2011, a stay of the proceedings with the intention of providing a window for settlement. The Settlement window so agreed was unsuccessful in achieving settlement between the parties.

- 7.3 Procedurally, therefore, the provisions of Article 26(2) have now been met.
- 7.4 In the Republic's respectful submission the retrospective attempt to correct the procedural flaws of the Claimants' failure to comply with the requirement for a "cooling-off period" in filing the request for arbitration on 26 July 2010, in no way affects the fact that the request for arbitration was substantively flawed. The "cooling-off period" must be seen as more than a short window of reflection to encourage settlement. It is far more than a procedural box to be ticked (though in the present claim the Claimants failed to satisfy even this requirement).
- 7.5 Rather, the cooling-off period is an important, substantive safeguard for a Contracting Party respondent, and is central to the question of its consent to arbitration. The cooling-off period allows a respondent State time to understand and grapple with the issues underlying the threatened claim and permits it the time required to put into motion the machinery of the State, through the proper channels of government communication, required to prepare itself to engage in the arbitration. As the Claimants failed to comply with the cooling off period in this case, the Republic was denied its right under the ECT to a three-month period of reflection but also preparation, which meant that it has been prejudiced, inter alia, by being unable to file a substantive and timely reply and by being denied its right to nominate an arbitrator. As such the Republic was really and substantially prejudiced at the outset of the arbitration. The Republic cannot be taken to have consented to arbitration in these circumstances when the safeguards of Article 26 were denied to it by the Claimants' failure to comply with that Article's clear requirements. The attempt retrospectively to correct such a substantive flaw is itself flawed, belated and misconceived.

Requirement for a cooling-off period in the ECT

- 7.6 Article 26(2) of the ECT provides as follows:
- "If [disputes between investors and a Contracting Party] can not be settled according to the provisions of paragraph (1) within a period of three months from the date on which either party to the dispute requested amicable settlement, the Investor party to the dispute may choose to submit it for resolution [...]"*
- 7.7 As conceded by the Claimants in paragraph 37 of the Statement of Claim, this effectively provides for a "cooling-off period" of three months between the date upon which a claimant

⁴³ Case # 118/2001. The ruling was issued on 16 December 2003 (**Exhibit C-281**)

notifies that it has a dispute with a Contracting Party and the date upon which it submits that dispute for arbitration.

The Cooling-off period was not satisfied

- 7.8 The essence of the Claimants' complaints in the Arbitration is that the Republic, over the course of the period from July 2008 to July 2010, took steps designed to prejudice the Claimants, with the ultimate goal to expropriate the Claimants' investments, culminating allegedly in the actions of direct expropriation on 21 July 2010.
- 7.9 The trigger for filing the Request for Arbitration on 26 July 2010 was, seemingly, the events of 21 July 2010. The Claimants plainly failed to fulfil the cooling-off requirement, instead filing a request for arbitration only 5 days after the day upon which it is alleged that the breach of the ECT occurred.
- 7.10 The Republic and Arbitral Tribunal have acknowledged that the cooling-off period was not satisfied, by agreeing / ordering by consent, a 90-day stay of the proceedings. This stay was unfortunately ultimately unsuccessful in achieving settlement between the parties.

The Cooling-off period is a jurisdictional requirement

- 7.11 Due observance of the cooling-off period is a matter that goes to the essence of the Arbitral Tribunal's jurisdiction because the cooling-off period is one of the safeguards enjoyed by Contracting Parties in return for their agreement to refer disputes to arbitration. This proposition was recognised by the Arbitral Tribunal in *Murphy v Ecuador*⁴⁴.
- 7.12 The *Murphy* case described the obligation for a cooling-off period under the BIT between Ecuador and the USA as constituting: "*a fundamental requirement that Claimant must comply with, compulsorily, before submitting a request for arbitration*"⁴⁵.
- 7.13 Further:

*"It is not an inconsequential procedural requirement but rather a key component of the legal framework established in the BIT and in many other similar treaties, which aims for the parties to attempt to amicably settle the disputes that might arise resulting of the investment made by a person or company of the Contracting Party in the territory of the another State"*⁴⁶.

- 7.14 Moreover:

⁴⁴ *Murphy Exploration and Production Co Int'l v Republic of Ecuador*, ICSID Case No. ARB/08/4, Award on jurisdiction dated 15 December 2010. (Exhibit R-186)

⁴⁵ *Ibid.* at paragraph 149.

⁴⁶ *Ibid.* paragraph 151.

“[I]t is not about a mere formality, which allows for the submission of a request for arbitration although the six-month waiting period requirement has not been met, and if the other party objects to it, withdraws and resubmits it. It amounts to something much more serious: an essential mechanism enshrined in many bilateral investment treaties, which compels the parties to make a genuine effort to engage in good faith negotiations before resorting to arbitration.”⁴⁷

- 7.15 A similar conclusion was reached in *Burlington v Ecuador*⁴⁸ where the arbitral tribunal, in finding that claims were inadmissible because the investor had not made any allegations of treaty breach prior to filing its request for arbitration, said that:

“[The cooling-off provisions of the BIT] requires the investor to inform the Host State that it faces allegations of Treaty breach which could eventually engage the Host State’s international responsibility before an international tribunal.”

The stay of the proceedings does not cure the jurisdictional deficiency

- 7.16 The agreed stay was in no way dispositive of the Republic’s jurisdictional argument that only an arbitral tribunal constituted after a proper reference under Article 26 of the ECT can have jurisdiction. The cooling-off period operates as a condition precedent to the entitlement to protection under the ECT and to the jurisdiction of the Arbitral Tribunal. The Republic cannot be taken to have consented to the jurisdiction of the Arbitral Tribunal in the present case, since a condition precedent to such jurisdiction, imposed by the Republic and its counterparties to the ECT, has not been met by the Claimants.

Prejudicial effect

- 7.17 It is noted that if the Claimants had acted properly in respecting the “cooling-off period” required by Article 26 ECT, before commencing this Arbitration, the procedural unfairness experienced by the Republic at the beginning of the case, in which the SCC constituted the Arbitral Tribunal before the Republic had filed an Answer or even retained legal counsel, could have been avoided.
- 7.18 In summary:
- (a) There was in fact no notice in respect of the dispute now pursued made by the Claimants to the Republic satisfying Article 26(2) ECT;

⁴⁷ Ibid. paragraph 154.

⁴⁸ *Burlington v Ecuador*, Decision on Jurisdiction, 2 June 2010 (**Exhibit R-187**), see IIA Issues Note No.1 March 2011 “Latest Developments in Investor-State Dispute Settlement” available at www.unctad.org/diaa.

- (b) Absent appropriate notice and the observance of the three month "cooling-off" period, the right of the Investor to refer the dispute to arbitration had not arisen;
- (c) The reference to arbitration by the request of 26 July 2010 was accordingly flawed - the right to refer the dispute to arbitration not at that point having arisen;
- (d) The Republic cannot be taken to have consented to the arbitration of the dispute in such circumstances;
- (e) The Arbitral Tribunal appointed accordingly does not have jurisdiction;
- (f) Attempts retrospectively to correct that flaw by agreeing a settlement window are misconceived and not dispositive of the issue; and
- (g) Any contrary interpretation in circumstances where the Republic did not for example take any part in the procedure establishing the Arbitral Tribunal, would unfairly prejudice the Republic's position in the arbitration.

8 No jurisdiction racione personae: None of the Claimants have demonstrated that they are "investors" under the ECT

8.1 As the Claimants rightly assert at paragraph 25 and 26 of the Statement of Claim, Article 26 of the ECT provides for the settlement of disputes between "investors" and the Contracting Parties and, further, provides at Article 26(2) for the submission by Investors of disputes to arbitration. Accordingly, those persons qualifying as "Investors" under the ECT have capacity to submit claims related to their protected Investments to arbitration.

8.2 Article 1(7) of the ECT defines an Investor as:

"(a) with respect to a Contracting Party:

(i) a natural person having the citizenship or nationality of or who is permanently residing in that Contracting Party in accordance with its applicable law; (ii) a company or other organization organized in accordance with the law applicable in that Contracting Party."

8.3 The consequences of the definition are that if an individual has the nationality or citizenship of a Contracting Party, then he will have capacity to bring a direct claim against the Host State on the basis he is a protected investor under the provisions of the ECT.

8.4 Similarly if a company is organised in accordance with the laws of a Host State, that company will have capacity to bring a direct claim against the Host State on the basis that it is a protected Investor under the provisions of the ECT.

- 8.5 In respect of the two corporate Claimants, Terra Raf and Ascom, each have failed to make out its case that it is entitled to the protections afforded under the ECT as an "Investor".
- 8.6 In relation to the two natural person Claimants, Anatolie Stati and Gabriel Stati, both have failed to evidence the position asserted.

(a) **Corporate Claimants**

(1) Ascom

8.7 In relation to Ascom:

- (a) The benefits of the ECT do not extend to Ascom and are denied on the basis of article 17(1).
- (b) The claimants have failed to demonstrate that Ascom is incorporated in Moldova.
- (c) Ascom never gained clean title to the shares in KPM.⁴⁹
- (d) Ascom is not legitimately listed as a member of KPM.⁵⁰

Ascom is not an investor as per the ECT

8.8 Based on Article 17(1) of the ECT (**Exhibit C-1**), any company may be refused benefits under the ECT by any signatory State, if it:

- (a) belongs to citizens or nationals from a third state or is controlled by such citizens or nationals of a third State; and
- (b) does not conduct substantial operations in the territory of the Contracting Party where it is organised.

8.9 It is the Republic's assertion that the Claimants have not proved that Anatolie Stati owns Ascom. If the Claimants can prove that Anatolie Stati owns Ascom, the Republic asserts that Ascom is controlled by a citizen of a third state (Romania) and has no substantial operations in the territory of Moldava (sic).

(a) Definition of a "Third State"

The ECT does not provide a definition of the term "third State". As a result, the necessity for interpretation of the term arises.

⁴⁹ See section 13 below.

⁵⁰ See section 13 below.

- (i) Based on paragraph 4 of Article 31 of the Vienna Convention on the Law of International Treaties 1969 (**VCLT**) (**Exhibit C-203**), "*A special meaning shall be given to a term if it is established that the parties so intended*". The paragraph emphasizes the basic principle established as the basis for interpretation of international treaties: in interpretation of a treaty, no one term used in an international treaty can be reduced to only one of the possible meanings of that term (unless there is some indication of the intent of the parties). In other words, a term must be interpreted to include all its possible interpretations.
- (ii) So, for example:
- (A) in Article 1(7) of the ECT (**Exhibit C-1**) a "third state" is contrasted from a Contracting Party;
- (B) alternatively the relationships between a firm registered in the territory of Moldova (the first state) and the Republic of Kazakhstan (the second state), any other state (for example, Romania) could be interpreted as a third state. Paragraph 1 of Article 40 of the Vienna Convention on Diplomatic Relations of 1961 serves as an analogy:
- " If a diplomatic agent passes through or is in the territory of a third State...when returning to his own country, the third State shall accord him inviolability and such other immunities as may be required to ensure his transit or return."* (**Exhibit R-52**).
- (C) In this case, the "first" state is "his own" state, the "second" state is the state in which the diplomat "takes up his duties", and the "third" state is any other state that participates in the Vienna Convention on Diplomatic Relations of 1961 through whose territory the diplomat proceeds. That is, if a Kazakh diplomat would proceed to take up his duties in Moldova through Romania, then Romania would be recognized as a third state (although all three States - Kazakhstan, Moldova and Romania - are participants in the Vienna Convention on Diplomatic Relations of 1961).
- (iii) Therefore the interpretation of the term "third State" is entirely contextual. From the linguistic point of view the term "third" State is understood to mean a State which is not the first State or does not belong to the group of States. The definition of a "third" state depends on the context in which the term is used.
- (iv) So the term "third state" cannot be defined in the ECT by only one interpretation, and therefore as a state that does not participate in the ECT. If it is a matter of

Kazakh-Moldavan relations, then, in this context, Romania is a third state regardless of its participation in the ECT.

(b) The Lack of Business Operations in the Territory of Moldova:

In accordance with the information available on Ascom's website it is involved in projects for oil and gas production outside of Moldova (in Kazakhstan, Turkmenistan and Sudan) and conducts no significant activities in Moldova (**Exhibit R-53**).

(c) Non-Application of the ECT under Article 17(1):

- (i) Article 17 (1) (**Exhibit C-1**) provides "*each Contracting Party reserves the right to deny the advantages of this Part to...*".
- (ii) The phrase "reserves the right to deny the advantages" clearly denies the advantages of Part III (which contains the substantive protections to certain investors) in certain circumstances.
- (iii) Based on Article 17 (1) of the ECT (**Exhibit C-1**), any company may be denied the advantages under the ECT by any Contracting Party if it belongs to parties from a third state or is controlled by a third state. The Article does not state that parties from a third state cannot be simultaneously citizens of the state where the company is registered. Consequently, Stati's Moldovan citizenship (along with his Romanian citizenship) cannot impact on considering whether Ascom is in a third state.

8.10 Based on the above an interpretation of the term "third state" shows that Ascom cannot be viewed as an investor under the ECT, as the company is allegedly controlled by a citizen of a third state (Anatole Stati, a Romanian citizen) and does not have substantial activities in the territory of Moldova. If the company is owned or controlled by parties of a third state and does not have substantial activities in the territory of the State where it was established, it shall be denied the advantages under the ECT.

(2) Terra Raf

8.11 In response to paragraph 21 of the SoC:

- (a) It is denied that the ECT applies to Gibraltar, provisionally or otherwise.
- (b) Therefore, it is denied that the benefits of the ECT extend to Terra Raf. In particular:
 - (i) "provisional application" applies pending the ECT's entry into force;

- (ii) once the Treaty entered into force for the UK, provisional application of the ECT was “spent” for the UK and all overseas territories referred to in the UK’s declaration as to provisional application made upon signatory of the ECT;
 - (iii) the Treaty’s provisional application to Gibraltar did not require express revocation;
 - (iv) alternatively, considering the usual practice of the UK to expressly identify those overseas territories that are to be subject to any treaty the fact that Gibraltar was not mentioned in the instrument of ratification was clear notice that the UK intended that the Treaty should have no further application in Gibraltar.
- (c) It is denied (if alleged) in paragraph 31 of the Statement of Claim that the case *Petrobart v Kyrgyzstan* is a binding precedent or even that it may serve as guidance to the Arbitral Tribunal in this case since it was decided on the basis of different facts to those of this case.
- (d) It is not admitted that that Terra Raf is incorporated validly in Gibraltar.

Terra Raf is not an ECT Investor since the ECT does not apply to Gibraltar

(i) Gibraltar is a territory of the United Kingdom

- 8.12 The Claimants are correct that Gibraltar is part of the United Kingdom of Great Britain and Northern Ireland. Gibraltar is part of the United Kingdom by virtue of it being an overseas territory.
- 8.13 There are a number of territories that enjoy unequivocal independence in their internal affairs but for whose external affairs the United Kingdom is responsible. These territories include⁵¹:
- (a) The 14 Overseas territories including Gibraltar as well as Anguilla, the Bermuda Islands, British Antarctic Territory, British Territory in the Indian Ocean, the British Virgin Islands, the Cayman Islands, the Falkland Islands, Montserrat, Pitcairn Island, the Island of St. Helena and its dependent territories (Ascension Island and the Island of Tristan da Cunha), South Georgia and the South Sandwich Islands, the Turks and Caicos Islands, the sovereign support bases of Akrotiri and Dhekelia in Cyprus); and
 - (b) The Crown Dependencies (the Isle of Man, the Bailiwick of Jersey and the Bailiwick of Guernsey).
- 8.14 All of the above territories are under the sovereignty of the United Kingdom meaning that they do not have the right to initiate relations independently with other States.

8.15 Whilst it is an undisputed fact between the parties that Gibraltar is part of the UK by virtue of it being an overseas territory, it does not necessarily follow from this that the ECT applies to Gibraltar. It is necessary to properly analyse the facts and circumstances of the ECT coming into force as well as the UK's intention in this respect.

(ii) International Treaties and Overseas Territories

8.16 Pursuant to Article 29 of the Vienna Convention on the Law of Treaties of 1969 (**Exhibit C-203**):

"Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory".

8.17 In their book "British Overseas Territories", Ian Hendry and Susan Dickson comment on this provision of the Vienna Convention, stating that:

"it would seem that its inference is reasonably clear - if any other intent cannot be determined, either from the treaty itself or in some other manner, the state is responsible under the treaty in which it participates both with regard to the mother country and the overseas territories. This reflects the normal position in international law."⁵²

8.18 However, the UK's the approach to treaty ratification that it applies to Overseas Territories since 1967 and to the Crown Dependencies since 1950 is that if a treaty itself does not clearly refer to territorial applicability, the UK will not simply use of the phrase "*All territories under the sovereignty of Great Britain*" without indicating specific territories (as it previously did) but instead adopt the approach of stating in its instrument of ratification to which territories the treaty applies. What is more, most recently the practice of the UK has been to specifically name each individual territory in the ratification document even if all the territories are actually included in the ratification.

8.19 This approach, in the opinion of the government of the UK, meets the requirement of Article 29 of the Vienna Convention on the Law of Treaties of 1969 regarding establishing "*a different intention*" (**Exhibit C-203**).

8.20 Therefore, the UK has, as a general rule, adopted a practice of indicating its intention to bind specific territories which overrides the default position (as set out in Article 29 of the Vienna Convention) that a treaty is binding in respect of the Contracting Party's entire territory.

⁵¹ See Anthony Aust. Modern treaty law and practice. Second edition. - Cambridge University Press, 2007, pp.513-514 (**Exhibit R-44**).

⁵² Ian Hendry and Susan Dickson. British Overseas Territories Law – Oxford and Portland, p.255. (**Exhibit R-45**)

- 8.21 This approach may be seen in the declaration made by the UK upon **signing** the Treaty, in which it referred only to the UK and Gibraltar and did not mention any of the UK's other overseas territories and none of its crown dependencies. A further example is the declaration made upon **ratification**, which referred only to the Bailiwick of Jersey and the Isle of Man. The significance of this is discussed further below.

(iii) Signing of ECT and Provisional Application to Gibraltar

- 8.22 Article 40 of the ECT, which is specifically concerns the applicability of the ECT to territories, states the following:

"Any state or Regional Economic Integration Organization may at the time of signature, ratification, acceptance, approval or accession, by a declaration deposited with the Depository, declare that the Treaty shall be binding upon it with respect to all the territories for the international relations of which it is responsible, or to one or more of them. Such declaration shall take effect at the time the Treaty enters into force for that Contracting Party."

"Any declaration made under the two preceding paragraphs may, in respect of any territory specified in such declaration, be withdrawn by a notification to the Depository. The withdrawal shall, subject to the applicability of Article 47(3), become effective upon the expiry of one year after the date of receipt of such notification by the Depository."⁵³

- 8.23 As regards provisional application, Article 45 of the ECT provides:

*"(1) Each signatory party agrees to apply this Treaty provisionally **pending its entry into force for such signatory** in accordance with Article 44, to the extent that such provisional application is not inconsistent with its constitution, laws or regulations.*

...

(3)(a) Any signatory may terminate its provisional application of this Treaty by written notification to the Depository of its intention not to become a Contracting Party to the Treaty [emphasis added]."⁵⁴

- 8.24 A similar regime is provided by Article 25 of the Vienna Convention on the Law of Treaties of 1969 (**VCLT**):

⁵³ Exhibit C-1

⁵⁴ Exhibit C-1

"1. A treaty or a part of a treaty is applied provisionally pending its entry into force if:

(a) the treaty itself so provides; or

(b) the negotiating States have in some other manner so agreed."

8.25 The Claimants plead correctly at paragraph 31 of the Statement of Claim that the United Kingdom, upon the signing of the ECT on 17 December 1994, declared, in accordance with Article 45(1) of the ECT:

"The Government of Great Britain and Northern Ireland declares that, with regard to its signing of the ECT, provisional application in accordance with Article 45(1) will be effective in Great Britain and Northern Ireland, and in Gibraltar" (Exhibit R-47).

8.26 Therefore the United Kingdom made its intention clear when it signed the ECT, that it would apply provisionally to Gibraltar, pending the entry into force of the treaty. It is clear from the wording of Article 45(1) that the provisional application ends when the treaty comes into force (discussed further below).

(iv) Consultations

8.27 From the point of view of constitutional law, the United Kingdom has the right to apply (or refuse to apply) treaties to Territories without consulting them, as long as the application of the Treaty is completely and exclusively the responsibility of the government of the United Kingdom, and not the governments of the Territories.

8.28 Along with this, a practice has developed of holding consultations prior to making a decision on the applicability of the treaty to a Territory⁵⁵. In accordance with international law, the United Kingdom takes responsibility for the required compliance with international treaty commitments by its Overseas Territories. Therefore it must ensure that the Overseas Territory is not only prepared to assume the obligations under the international treaty, but also in a position to fulfil them. For each new international treaty in which the United Kingdom intends to participate a "Consultation Document" is prepared for the Territories. It must be prepared under the assumption that the Territory has no information on the given issue. The information presented must be sufficient for the Territorial government to be able to understand the contents of the treaty and to make a choice. Only in exceptional cases does the United Kingdom act without considering the opinion of the Territorial governments.

⁵⁵ See Memorandum on Application (Exhibit R-193)

- 8.29 The UK's clear intention that the ECT should not apply in Gibraltar is confirmed by a note verbale dated July 27, 2004 in response to the note verbale 78/2004 filed on behalf of the United Kingdom at the depositary in Lisbon (the Government of Portugal), which stated the following:

"The UK did apply the Energy Charter Treaty provisionally to the UK and Gibraltar at signature. However, the Government of Gibraltar subsequently informed Her Majesty's Government that they did not wish to seek ratification of the Treaty, since at that time the Treaty would not have had any practical effect for the territory. Gibraltar was therefore not included in the UK's instrument of ratification relating to the Treaty, deposited on 17 December 1997." (**Exhibit R-51**)

- 8.30 Therefore it is clear that Gibraltar did not want the United Kingdom to ratify the ECT on its behalf and therefore the UK deliberately did not include Gibraltar in the ratification document.

(v) Ratification of the ECT

- 8.31 The United Kingdom ratified the ECT on 13 December 1996 (**Exhibit R-48**).

- 8.32 Pursuant to Article 40 of the ECT⁵⁶, and as set out at paragraph 8.22 above, the Contracting Party can declare "at the time of signature, ratification, acceptance, approval or accession" that the Treaty shall be binding with respect to the territories of which it is responsible.

- 8.33 When the UK ratified the ECT, it made it clear, in accordance with its practice of naming those overseas territories and crown dependencies in which a treaty is to apply, that the ECT would apply to two of the three Crown Dependencies - to the Bailiwick of Jersey and the Isle of Man and to no other Crown Dependency. In particular, there was no declaration at this time that the ECT would apply to Gibraltar.⁵⁷

(vi) Termination of Provisional Application

- 8.34 Provisional application of the ECT will cease:

- (a) by virtue of the Treaty coming into force pursuant to Article 45(1); or
- (b) by virtue of a written notification pursuant to Article 45(3)(a).

- 8.35 As to the giving of notice, Article 45(3)(a) states that:

⁵⁶ Exhibit C-1

⁵⁷ Under the principle expression unius est exclusion alterius, silence of Great Britain in respect of Gibraltar in conjunction with an obvious indication at the application of the Treaty to the Bailiwick of Jersey and the Isle of Man can be interpreted as follows: Gibraltar was excluded from the scope of the ECT from the moment of its full entry into effect for the United Kingdom. "*The Sun never sets: provisional application and the Energy Charter Treaty*," Alexandre de Gramont and Emily M. Alban. In the treatise *Energy Dispute Resolution: Investment Protection, Transit and the Energy Charter Treaty*. Edited by Graham Coop, JurisNet, LLC, New York, 2011, стр. 225 (**Exhibit R-50**).

“Any signatory may terminate its provisional application of this Treaty by written notification to the Depositary of its intention not to become a Contracting Party to the Treaty.”

8.36 A similar regime is contained in the Article 25 VCLT of which provides:

“Unless the treaty otherwise provides or the negotiating States have otherwise agreed, the provisional application of a treaty or a part of a treaty with respect to a State shall be terminated if that State notifies the other States between which the treaty is being applied provisionally of its intention not to become a party to the treaty.” (Exhibit C-203)

8.37 It is notable that only a State which has not become a participant (that is, for which the treaty has not been ratified and entered into full force) can give notice under Article 25 of the Vienna Convention, since Article 2(g) of the Vienna Convention provides that “party” means a State which has consented to be bound by the treaty and for which the treaty is in force”.

8.38 This is logical and consistent with the fact that provisional application also comes to an end upon ratification by a State, at which point that State is no longer “a party” under the terms of the treaty. Although the ECT does not go to the same lengths as the VCLT, the principle is nevertheless applicable to it, as recognised by Roe and Happold in their commentary on the *Petrobart* case:

“Once the Treaty entered into force for the UK ... [the regime of provisional application] ought to have been regarded as spent as far as the UK was concerned. The Treaty’s provisional application to Gibraltar did not require express revocation; and the natural inference from the failure to mention Gibraltar in the instrument of ratification ought to have been that the UK did not intend the Treaty to apply to Gibraltar.”⁵⁸

8.39 The ECT entered into force in the United Kingdom on 16 April 1998. Accordingly the provisional application was de facto terminated on that date in respect of the United Kingdom and all sovereign territories of the UK, including Gibraltar.

8.40 Even if considered from the perspective of termination by notice under Article 45(3), the position is the same. Taking into consideration the United Kingdom’s practice since 1967 of expressly naming those overseas dependencies in which a given treaty is to apply, the terms of the United Kingdom’s ratification of the ECT constituted clear and unequivocal notice that the ECT should

⁵⁸ Settlement of Investment Disputes under the Energy Charter Treaty, by Thomas Roe and Matthew Happold, page 70 (Exhibit R-207)

have no further application to Gibraltar provisionally or otherwise, following its entry into force upon ratification.

- 8.41 The termination of provisional application of the ECT to Gibraltar (whether by ratification or the giving of notice) is confirmed by the fact that the lists of international treaties applicable to overseas territories that are maintained by the Foreign and Commonwealth Office of Great Britain do not mention the ECT as being applicable (even provisionally) to Gibraltar (**Exhibit R-49**). It is clear therefore that the ECT does not apply to Gibraltar.

(vi) The "Petrobart v Kyrgyzstan" Case

- 8.42 The Claimants seek to rely on the case of *Petrobart Ltd. (Gibraltar) v. Kyrgyzstan* (Case No. 126/2003) (**Petrobart**) (**Exhibit C-204**) which was referred to the Arbitration Institute of the SCC pursuant to the ECT in support of their argument that the ECT applies to Gibraltar. The decision by the arbitral tribunal in this case was given on 29 March 2005.
- 8.43 However not only is the case not binding on the Arbitral Tribunal, given that there is no concept of binding precedent in international arbitration, as discussed below, the facts of *Petrobart* are sufficiently distinct that the case is of no assistance to the Arbitral Tribunal in the current case.
- 8.44 In particular and crucially, the arbitral tribunal in *Petrobart* considered the application of the ECT to Gibraltar in the context of investments which were made during the period of the provisional application of the ECT, but prior to its entry into force following ratification. In the present case, the alleged investments were made by the Claimants several years after ratification, by which time the ECT had ceased to have any effect in Gibraltar whether because provisional application was brought to an end by the ECT coming into force upon ratification or by notification under Article 45(3).
- 8.45 *Petrobart* was a company registered in Gibraltar. The company was owned by two individuals that were citizens of countries that were not signatories of the ECT. These individuals could not be regarded as indirect investors, and so the question of whether the ECT extended to Gibraltar was a primary issue.
- 8.46 The respondent (Kyrgyzstan) raised the objection that the ECT did not extend to Gibraltar at a rather developed stage in the proceedings. Notwithstanding the issue of whether the respondent was estopped from raising such a defence at such a late stage, the arbitral tribunal opined on the applicability of the ECT to Gibraltar.
- 8.47 In the arbitral tribunal's view, if the United Kingdom had wanted to terminate the provisional application of the ECT with regard to Gibraltar, it would have submitted the corresponding notification required by Article 45(3)(a). Furthermore, the arbitral tribunal said:

"The fact that the ratification, for political or other reasons, did not include Gibraltar does not justify the conclusion that the United Kingdom intended to revoke the applicable of the Treaty to Gibraltar on a provisional basis."⁵⁹ The decision of the arbitral tribunal was that, in the specific circumstances of the case, the ECT was extended to Gibraltar.

8.48 However, the decision in *Petrobart* does not affect the position in this arbitration for several reasons:

- (a) The arbitral tribunal in *Petrobart* admitted that the situation "*where the territory accepted for provisional application and for application upon ratification does not coincide*"⁶⁰ was an unusual one and that there was no rule to be found in the ECT. The arbitral tribunal's decision was therefore merely one interpretation of the relevant provisions, given the facts presented. It does not represent the definitive view on the issue of the applicability of the ECT to Gibraltar.
- (b) The unusual situation in which the arbitral tribunal in the *Petrobart* case was required to make a decision does not apply here. The arbitral tribunal in *Petrobart* was deciding whether the ECT applied where the original document of signature and the ratification document both fell to be considered but were inconsistent. In the present case there is no inconsistency because the document of signature does not need to be considered. The ECT provides a complete mechanism for the cessation of the provisional application; once the ECT comes into force the provisional application ceases. The ECT came into force on 16 April 1998 and this is the date on which the applicability of the ECT to Gibraltar terminated, some six years before Terra Raf is alleged to have acquired its alleged investments and some ten years prior to the alleged breaches of the ECT. Therefore, in this case the Arbitral Tribunal need only consider the terms of the ratification document to establish whether the ECT applied in Gibraltar at the relevant time, which it did not.
- (c) Investments (as defined in the ECT) were made by Petrobart and expropriated by Kyrgyzstan in the period following the ratification of the ECT by the UK, but prior to it entering in force for the UK, that is in the period of time in which the provisional application of the ECT with regard to Gibraltar applied. Petrobart concluded its investment contract in February 1998, produced unpaid deliveries (i.e. made "investments" which were "expropriated") in February-March of 1998 (i.e. before the ECT came into force in the UK).

⁵⁹ Petrobart case (Exhibit C-204 page 63)

⁶⁰ Petrobart case (Exhibit C-204 page 62)

- (d) It is precisely because of this issue as to timing that the question of the necessity of notification arose. However, where investments took place after the ECT entered in force for the United Kingdom, there is no issue as to the provisional applicability of the ECT in Gibraltar; it simply doesn't apply, so the arbitral tribunal's conclusion in *Petrobart* is irrelevant and inapplicable to this dispute.
- (e) In particular the decision of the arbitral tribunal in *Petrobart* concerning the requirement for notice does not affect the position here because this case is not affected by this issue of timing. In *Petrobart*, the arbitral tribunal was considering investments prior to the point when the Treaty came into effect on ratification, at which time it was still possible (and necessary) to give notice to terminate its preliminary application. Here TNG's alleged investments were made several years after the Treaty came into effect, at which point preliminary application had ended automatically and it was not longer possible or necessary to give notice.
- (f) Furthermore to the extent notice is found to be required to terminate preliminary application, it is necessary to consider the fact that, consistent with the UK's long established practice to expressly state which of its overseas territories should be subject to a treaty, the terms of the UK's ratification document were clear notice that the UK intended to end the application of the ECT in Gibraltar. Once again that is not inconsistent with the finding in *Petrobart* because of the above issue of timing. The notice given by way of the ratification document is only effective upon the coming into force of the Treaty. Therefore in the situation in *Petrobart*, the notice was not effective until after the claimants investments had been made. In this arbitration, the notice was effective long before TNG's alleged investments are said to have been made.

8.49 Moreover, even if the decision in *Petrobart* were to be considered influential here, the decision has been criticised on the basis that the correct analysis should be that the Contracting Parties have to "opt in" on ratification rather than "opt out". The arbitral tribunal stated that "*it could indeed be expected that the United Kingdom, if it wished the provisional application of the Treaty to Gibraltar to be terminated as a result of a ratification not including Gibraltar, should have made this clear by making a notification in line with Article 45(3)(a) or a declaration in some other form in connection with the ratification.*"⁶¹ However there is no justification for this conclusion and it can equally be turned on its head and argued that if the UK intended the ratification to include Gibraltar or for preliminary application to continue it should have made it clear by a declaration to that effect at the time of ratification.

8.50 Roe and Happold have, for example, said of the decision in *Petrobart*:

⁶¹ Petrobart case (Exhibit C-204 page 62)

“It may be doubted whether the tribunal was right. Provisional application is a regime which applies pending [the Treaty’s] entry into force. Once the Treaty entered into force for the UK [...] that regime ought to have been regarded as spent as far as the UK was concerned. The Treaty’s provisional application to Gibraltar did not require express revocation; and the natural inference from the failure to mention Gibraltar in the instrument of ratification ought to have been that the UK did not intend the Treaty to apply to Gibraltar.”⁶²

(vii) Conclusion:

- 8.51 It is clear that there is no binding precedent with respect to previous decisions of arbitral tribunals and that there is therefore no obligation on the Arbitral Tribunal to come to the same conclusion as the arbitral tribunal did in the case of *Petrobart*.
- 8.52 It is obvious that the facts and circumstances in the case of *Petrobart* are not relevant for considering the issues in dispute in this matter. In particular, in *Petrobart* the ECT had not come into force at the date of the relevant investments. Whereas in this arbitration TNG’s investments were made several years after it came into effect. Therefore the arbitral tribunal’s decision does not reflect the fact that preliminary application of the ECT ceased upon its ECT coming into force.
- 8.53 The arbitral tribunal’s comments in *Petrobart* concerning the requirement for notice are not inconsistent with a finding in this arbitration that preliminary application terminates automatically upon the Treaty coming into force or, alternatively that the UK’s ratification document is effective notice to terminate the preliminary application of the Treaty to Gibraltar.
- 8.54 Consequently, Terra Raf Trans Trading Ltd cannot rely on the provisions of the ECT, because it is a company established in Gibraltar and, for the reasons set out above, the ECT does not apply to Gibraltar.
- 8.55 Therefore the situation with regards to the applicability of the ECT to Gibraltar is clear; there is no issue of ambiguity or inconsistency.
- (a) When the ECT came into force following ratification by the UK on 16 April 1998⁶³, preliminary application of the ECT to the UK and Gibraltar ceased automatically;
 - (b) Alternatively, the UK gave clear notice in its ratification document that it intended the preliminary application of the ECT in Gibraltar to cease on the date the ECT came into force.

⁶² Settlement of Investment Disputes under the Energy Charter Treaty, by Thomas Roe and Matthew Happold, page 70 (**Exhibit R-207**)

⁶³ **Exhibit R-48**

(b) Natural persons**(1) *Anatolie Stati*****General information**

8.56 Paragraph 29 of the Statement of Claim states that Anatolie Stati has dual citizenship for Moldova and Romania. The following documents have been exhibited to the Statement of Claim as proof:

- (a) a Moldovan passport;
- (b) an identification ballot;
- (c) an identification card (**Exhibit C-29.1**); and
- (d) a Romanian passport (**Exhibit C-29.2**)⁶⁴.

8.57 Anatolie Stati cannot be seen as an Investor according to ECT:

- (a) He has not made any direct investments in Kazakhstan.
- (b) He cannot be seen as an indirect Investor via Ascom as, for the reasons set out in paragraph 13 below, did not have any legal Investments in Kazakhstan (and had no rights to KPM LLP, which was allegedly the contractor under Contract 305).
- (c) He also cannot be seen as an indirect investor via Terra Raf due to the following:
 - (i) the Claimants have not provided any documents proving that he owns this firm or has any control over it;
 - (ii) this company did not have any legal investments in Kazakhstan (and had no rights to TNG LLP, which was allegedly the contractor under Contracts 210 and 302) as detailed above.
- (d) Neither can he be seen as an indirect investor via any other firm, as he did not hold the legal capacity to act as an Investor.

8.58 It is necessary to elaborate on some of the points mentioned above.

⁶⁴ We assume that Anatolie Stati has dual Moldovan and Romanian citizenship. However, according to his Moldovan identification card (**Exhibit C-29.1**), Anatolie Stati permanently resides in Moldova, at the following address: Chisinau (Kishinev) 20 Dragomirna Street According to his Romanian passport (**Exhibit C-29.2**) Anatolie Stati permanently resides in Romania (in Bucharest). Thus, Anatolie Stati permanently resides in both Moldova and Romania at the same time, which leaves his status at best unclear.

8.59 Anatolie Stati does not have rights to Terra Raf or Ascom:

- (a) The Statement of Claim asserts that Anatolie Stati owns 50% of Terra Raf (paragraph 32 of The Statement Claim). The evidence which allegedly shows this is Exhibit C-32, which does not in any way state that Anatolie Stati owns 50% of the company. Furthermore, **Exhibit C-33**, lists two British firms as the founders of Terra Raf Trading Ltd. (pages 6, 15) (Southbridge Services Limited and Crestmount Services Limited). Given this evidence, the Claimants are put to proof as to how it is asserted that Terra Raf owns TNG.
- (b) According to paragraph 32 of the Statement of Claim, Anatolie Stati owns 100% of Ascom (**Exhibit C-35**). As for the reasons set out above, Ascom is not an investor, Anatolie Stati also cannot be considered as an indirect Investor in the meaning of the ECT.

8.60 Anatolie Stati does not have the capacity to act as an Investor in The Republic of Kazakhstan

- (a) Anatolie Stati as an individual does not have the legal capacity to act as an Investor in Kazakhstan. Thus, he cannot be legitimately considered to be an Investor in The Republic of Kazakhstan.
- (b) According to the Kazakh law in force at the date, Ascom acquired KPM, an individual could only act as a foreign investor in Kazakhstan if he had the status of individual entrepreneur. Based on The Republic Of Kazakhstan Law on Foreign Investments dated 27 December 1994 No.266-XIII (article 1), only the following persons were mentioned as foreign investors "*foreign citizens...provided they are registered to conduct business in the country of their citizenship or permanent residence*" (**Exhibit R-55**).
- (c) In Moldova, the status of an individual entrepreneur is obtained by means of registration as an individual entrepreneur. In the period when Anatolie Stati began his activity in the Republic, the Moldavan Law on entrepreneurship and enterprise 3845-XII dated 3 January 1992 was in effect and as stipulated in Articles 13-14 it required the registration of individual enterprises. Furthermore, it was the only possible type of entrepreneurial activity that could be carried out by an individual (paragraph 2 Article 14) (**Exhibit R-56**). Moldavan Law No. 220 dated 19 October 2007 "On state registration of legal entities and individual entrepreneurs" is currently in effect (**Exhibit R-57**). Based on article 2 of the law, only an individual registered as an individual entrepreneur has the legal capacity to carry out entrepreneurial activity in Moldova. The registered individual is provided with a state identification number (a number code that is also given to legal entities).

- (d) Anatolie Stati does not possess the status of individual entrepreneur. He did not possess the status of individual entrepreneur on the date when he started his "investments" in the Republic (December 1999) and in the process thereof.
- (e) This raises the question of how this relates to the ability to act as an indirect investor under the ECT. Anatolie Stati does not possess the legal capacity to be an Investor in the Republic, as he does not possess the status of individual entrepreneur, which means he cannot exercise rights as an investor under the ECT. As an explanation we could draw an analogy with a child. The ECT assumes that an individual can act as an Investor. However this does not mean that a three year old child can be considered as an Investor, because the child does not have legal capacity, i.e. the right to exercise rights.
- (f) As Anatolie Stati does not possess the status of individual entrepreneur, he cannot have the legal capacity to act as an Investor.

8.61 Thus, Anatolie Stati can only be considered as an individual indirect Investor if he possesses the status of individual entrepreneur. As he does not possess this status he cannot attract the benefits afforded to investors under the ECT.

(2) Gabriel Stati

8.62 In relation to Gabriel Stati:

- (a) Gabriel Stati, according to The Statement of Claim is a citizen of Moldova and Romania, however the fact of citizenship is not confirmed by any documents. No passport copies have been provided. As proof of dual citizenship and identification card for Romania and an identification ballot of Moldova have been provided. The Claimants have not proved that the aforementioned documents confirm citizenship.
- (b) Based on the documents provided, Gabriel Stati has no connection to the Investments in question in this case, and cannot be considered as either a direct, or an indirect Investor.
- (c) Thus, none of the documents provided as appendices to the Statement of Claim contain proof that Gabriel Stati is a direct or an indirect Investor according to ECT.

9 No jurisdiction materiae: No “investments”

9.1 In keeping with the approach taken throughout the Statement of Claim, the Claimants have failed to assist the Arbitral Tribunal in assessing, on any more than a cursory basis, whether or not the alleged investments constitute investments attracting protection under the ECT.

9.2 In a striking omission, the Claimants have failed to adequately particularise and evidence which investments are allegedly owned by which investors. The failure to demonstrate the connection

between each of the Claimants and any of the alleged investments is a determinative blow to the Claimants' case.

9.3 The following sets out the considerations that the Claimants should have addressed in establishing that they have made "Investments" in accordance with the ECT.

(i) General requirements and relevant international law standards relating to the concept of "investment"

9.4 In the case of *Phoenix Action Ltd v The Czech Republic*⁶⁵ (**Phoenix**) heard under the auspices of ICSID, the arbitral tribunal referred to 6 basic characteristics of investments:

- (a) a contribution in money or other assets;
- (b) a certain duration;
- (c) an element of risk;
- (d) an operation made in order to develop an economic activity in the host State;
- (e) assets invested in accordance with the law of the host State;
- (f) assets invested bona fide.

9.5 These characteristics replicate the already readily accepted principles by international investment tribunals in the ICSID case of *Salini Costruttori SpA v Morocco*⁶⁶. Phoenix mentions two additional "requirements": namely that the assets should be invested in accordance with the law of the host State, and that assets are invested by the investor **bona fide**. In Phoenix, the arbitral tribunal referred to the importance of the general purpose of the protection granted by international law in explaining why it is justified to look at such wide factors when considering whether an assessment has been made:

"If doubts are raised with regard to the existence of a protected investment, the Tribunal has to conduct a contextual analysis of the existence of a protected investment, in order to decide whether or not the investment satisfies certain criteria additional to those analyzed above, that grant it international protection through the ICSID mechanism and the BIT. In other words, in order to conclude that an economic operation, which by its nature is or looks like an investment, is indeed an investment deserving international protection, the Tribunal must also take into consideration the purpose of the international protection of the

⁶⁵ Phoenix Action Ltd v The Czech Republic, ICSID Case No. ARB/06/5, Award dated April 15, 2009. (**Exhibit R-31**)

⁶⁶ Salini Costruttori SpA v Morocco (ICSID Case No. ARB/00/4) referred to at paragraph 83 of Phoenix (**Exhibit R-31**)

investment, whether it is the specific purpose of the ICSID system or the general (purpose of the protection granted by international law.”⁶⁷

9.6 In any event, these additional “requirements” are both expressions of well-established principles of international law and therefore are relevant for consideration by this Arbitral Tribunal.

9.7 Accordingly, in *Plama v. Bulgaria*⁶⁸, the arbitral tribunal found that notwithstanding that the ECT does not contain explicit wording stating that the investment must be made in conformity with the host state’s law, the substantive protections of the Energy Charter Treaty do not extend to investments made contrary to that law.

9.8 Further, as explained by Roe and Happold:

“an approach which begins by analysing the content of the alleged “Investment” under the law of the Host State is entirely “in accordance with the ECT since the ECT requires the Arbitral Tribunal to analyse whether what the claimant alleges to be an “investment” constitutes an “asset” as defined in Article 1(6), a question which cannot sensibly be answered without reference to the law of the Host State.”

⁶⁹

9.9 Further, in *Hoachoozo Palestine Land and Development Co*, it was further held that:

“In a case in which complaint is made that governmental authorities have confiscated contractual property rights, the preliminary question is one of domestic law as to the rights of the claimant under a contract in the light of the domestic proper law governing the legal effect of the contract.”⁷⁰

9.10 As set out fully below, the principle of good faith is an established one under international law.

(ii) “Investment” under the ECT

9.11 In addition to the Arbitral Tribunal satisfying itself that the investment meets the general characteristics of an “investment”, each investment needs to fall into the definition of investment as articulated by the ECT itself.

9.12 Article 26(1) provides that:

⁶⁷ Paragraph 79 of Phoenix case (**Exhibit R-31**)

⁶⁸ **Exhibit R-32**

⁶⁹ Settlement of Investment Disputes under the Energy Charter Treaty (by Thomas Roe and Matthew Happold) page 51 (**Exhibit R-207**)

⁷⁰ F. Nielsen, *American - Turkish Claims Settlement under the Agreement of 24 December 1923* (Washington: US Department of State, 1937), p.254 as cited in Douglas, *The International Law of Investment Claims*, Cambridge University Press, 2009 page 41 (**Exhibit R-171**)

*“Disputes between a Contracting Party and an Investor of another Contracting Party relating to an **Investment** of the latter in the Area of the former, which concern an alleged breach of an obligation of the former under Part III [of the ECT] shall, if possible, be settled amicably.”⁷¹ [Emphasis added]*

9.13 According to 1(6) of the ECT:

*““Investment” means every kind of **asset** associated with an economic activity in the energy sector which is **owned or controlled directly or indirectly by an Investor** and includes:*

(a) tangible and intangible, and movable and immovable, property, and any property rights such as leases, mortgages, liens, and pledges;

(b) a company or business enterprise, or shares, stock, or other forms of equity participation in a company or business enterprise, and bonds and other debt of a company or business enterprise;

(c) claims to money and claims to performance pursuant to a contract having an economic value and associated with an Investment;

(d) Intellectual Property;

(e) Returns;

(f) any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any “Economic Activity in the Energy Sector

*A change in the form in which assets are invested does not affect their character as investments and the term “Investment” includes all investments, either **existing or made after the later of the date of entry into force of this Treaty** for the Contracting Party of the Investor making the investment and that for the Contracting Party in the Area of which the investment is made (hereinafter referred to as the “Effective Date”) provide that the Treaty shall only apply **to matters affecting such investments after the Effective Date.**”⁷² [Emphasis added]*

9.14 According to Article 1(5) of the ECT:

““Economic Activity in the Energy Sector” means economic activity concerning the exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing, or sale of “Energy Materials and Products” except

⁷¹ Exhibit C-1

those included in Annex NI, or concerning the distribution of heat to multiple premises. “

The ECT contains a Four-Limbed “Investment” Test

9.15 Accordingly, under the ECT, the Claimants must establish that each of the alleged investments falls within the following four-limbed test. The alleged investment:

- (a) In accordance with the law, is an asset falling within article 1(6);
- (b) Which is owned or controlled directly or indirectly by an Investor;
- (c) Existing of Made after the Effective Date (where matters affecting the investments occur after the Effective Date); and
- (d) in the Area of the Contracting Party.

Limb One: Asset

9.16 The ECT contains a definition of investment. This is broad, but not unlimited. The recognised characteristics of an investment as set out in Phoenix have been discussed above. In addition, it is noted that a number of the assets listed in Article 1(6) are qualified by the definitions of those assets and also that while the ECT does protect certain investments prior to the entry into force of the ECT in the host / home State (whichever is later), the matters affecting those investments must occur when the ECT is effective in both home and host State. Notably, while there is a general catch-all allowing “*any right conferred by law or contract or by virtue of any licences and permits*” to benefit from the ECT (in circumstances), this will only be where those rights are granted “*pursuant to law*” which reflects the position as expressed in Phoenix.

Limb Two: Owned or Controlled directly or indirectly by an Investor

9.17 Understanding 3 of the ECT provides the following guidance:

“For greater clarity as to whether an Investment made in the Area of one Contracting Party is controlled, directly or indirectly, by an Investor of any other Contracting Party, control of an Investment means control in fact, determined after an examination of the actual circumstances in each situation. In any such examination, all relevant factors should be considered, including the Investor’s

(a) financial interest, including equity interest, in the Investment;

⁷² Exhibit C-1

(b) ability to exercise substantial influence over the management and operation of the Investment; and

(c) ability to exercise substantial influence over the selection of members of the board of directors or any other managing body.

Where there is doubt as to whether an Investor controls, directly or indirectly, an Investment, an Investor claiming such control has the burden of proof that such control exists.”⁷³

- 9.18 The Claimants are required to demonstrate that the alleged investment is either owned or controlled (either directly or indirectly) by an Investor under the ECT. In other words, there must be a connection between the Investor and the Investment.

Limb Three: Existing of Made after the Effective Date (where matters affecting the investments occur after the Effective Date)

- 9.19 The Claimants are required to demonstrate that each of the alleged investments were made after the date the ECT came into force (either for the home State of the Investor or for the host State (whichever is later)) (defined as the Effective Date).

- 9.20 Alternatively, if existing prior to the Effective Date, that the matters affecting the investment occurred after the Effective Date.

Limb Four: The Area of the Contracting Party

- 9.21 Article 1(10) of the ECT provides that:

“Area means with respect to a state that is a Contracting Party:

(a) the territory under its sovereignty, it being understood that territory includes land, internal waters and the territorial sea; and

(b) subject to and in accordance with the international law of the sea: the sea, seabed and its subsoil with regard to which that Contracting Party exercises sovereign rights and jurisdiction....”⁷⁴

(iii) The Claimants’ failure to prove that there is any investment

- 9.22 At paragraph 34 of the Statement of Claim, the Claimants state that the Claimants’ investments “fall squarely” within the broad definition of investment. Further they allege that their investments

⁷³ Exhibit C-1

⁷⁴ Exhibit C-1

are “indisputably” associated with an Economic Activity in the Energy Sector. Rather than specify all the investments allegedly held by the claims, the Claimants state that they include:

- (a) various assets owned by KPM and TNG including oil and gas wells, drilling equipment, gathering pipelines, treatment and storage facilities, vehicles and offices;
- (b) the LPG facility;
- (c) equity interests in KPM and TNG; and
- (d) contractual rights conferred by the Republic to KPM and TNG under the contracts and licences for the Borankol field, the Tolkyn field, and the Contract 302 Properties.

9.23 Further the Claimants’ pleaded case provides no structured analysis as to how each of the investments allegedly qualifies as investments for the purposes of the ECT nor is it explained who owns which investments.

9.24 As set out above at Paragraph 5.8 - 5.115, it is not for the Republic to make out the Claimants’ case for them: the burden of proof lies with the Claimants. Therefore, the following is not exhaustive, but an indicative set of examples of the poor quality of the Claimants’ claim and the evidence that indicates strongly that no investments were made by the Claimants. In any case, the Republic’s observations regarding the alleged investments of the Claimants are set out in full in at Paragraph 13 below.

Investment not made in accordance with Kazakh law

9.25 In relation to KPM itself, the Arbitral Tribunal is referred to Paragraph 13. The Claimants are put to proof that in accordance with Kazakh law:

- (a) KPM was legally formed;
- (b) The relevant registrations occurred in relation to the initial issue of shares and the subsequent transfer to Ascom;
- (c) The relevant consents were sought in respect of procuring the Republic’s waiver of its pre-emptive rights;
- (d) The relevant formalities were followed when KPM was transferred from OJSC status to LLP status; and
- (e) The relevant formalities were carried out in respect to of extensions to the licence required to the licence pursuant to amendments to Contract 305.

9.26 In relation to TNG itself, the Arbitral Tribunal is referred to Paragraph 13. The Claimants are put to proof that in accordance with Kazakh law:

- (a) The relevant consents were obtained in relation to the acquisition of TNG;
- (b) The formalities were followed in respect of converting TNG from an OJSC to an LLP;
- (c) There was a lawful transfer from Gheso to Terra Raf (and that a waiver from the Republic of its pre-emptive rights was procured);
- (d) The relevant formalities were carried out in respect to extensions required to the licence pursuant to amendments to Contract 210 and 302; and
- (e) TNG owned Contract 302 at the relevant time (in 2008 when expropriation is alleged to have occurred) since the contract terminated on its own terms.

Little or no contribution by the investor

- 9.27 The *Salini*⁷⁵ test made clear that a "contribution" is a key component in establishing that an investment has been made. Whilst the contributions need not be financial, for example, transfer of know how, equipment or personnel may qualify as an investment, it was held in the case of *Bayindir v. Pakistan*⁷⁶ that "to qualify as an investment, the project in question must constitute a substantial commitment on the side of the investor⁷⁷." Arbitral tribunals may examine the magnitude of the claimant's total commitment (be it expenditure or non-financial commitment) in determining whether there is an investment. The amount of commitment made by the claimant should also be considered in relation to the overall project; it has previously been held in several cases⁷⁸ that where the claimant's contribution was substantial, but only amounted to a fraction of the overall project, it was not sufficient to be considered an investment.
- 9.28 In the light of this (as set out below) the Claimants are put to proof that the Claimants made any investment in the acquisition of KPM and TNG.
- 9.29 In relation to KPM:
- (a) The Claimants have advanced no evidence of the price paid to acquire KPM or the other terms of that transaction (for the reasons set out in paragraphs 14.1 and 14.2 there is evidence that the Claimants did not pay anything for this company). No copy of the share purchase agreement has been provided. Instead, they rely on three one page documents (**Exhibits C-47, C-48 and C-49**). Two, issued by the Agency of the Republic of Kazakhstan on Investments concerning a change of the founding member of KPM to

⁷⁵ *Salini Costruttori SpA v Morocco* (ICSID Case No. ARB/00/4) referred to at paragraph 83 of Phoenix (**Exhibit R-31**)

⁷⁶ *Bayindir Insaat Turizm Ticaret Ve Sanayi A. (Scedil) v. Pakistan* ICSID Case No. ARB/03/2 (**Exhibit R-208**)

⁷⁷ *Bayindir Insaat Turizm Ticaret Ve Sanayi A. (Scedil) v. Pakistan* ICSID Case No. ARB/03/2 (Decision on Jurisdiction of Nov.14, 2005), paragraph 131 (**Exhibit R-208**)

⁷⁸ See *Bayindir Insaat Turizm Ticaret Ve Sanayi A. (Scedil) v. Pakistan* ICSID Case No. ARB/03/2 (Decision on Jurisdiction of Nov.14, 2005) and *Malaysian Historical Salvors Sdn, Bhd v. Malaysia* ICSID Case No. ARB/05/10 (Award of May 28, 2007) as cited in *Investor-State Arbitration by Dugan et al*, OUP 2008, page 271 (**Exhibit R-206**)

Ascom. The last is a letter from KPM to the Agency on Investments Licenses and Contracts asserting that Ascom S.A. has become the founding member and requesting certain changes to Licence No.309. These documents do no more than suggest that Ascom acquired KPM and, in particular, disclose insufficient details to allow the legality of that acquisition to be confirmed or to establish the value of Ascom's alleged investment in the company.

- (b) Whilst the Claimants' evidence concerning Ascom's participation in KPM's acquisition is poor, they advance absolutely no evidence that Anatoli Stati, Gabriel Stati nor Ascom had any financial or other involvement in the transaction at all.

9.30 In relation to TNG:

- (a) Based on the consideration paid in each of the share purchase agreements the Claimants have disclosed (**Exhibits C-54, C-55, C-56, C-57, C-50 and C-60**), the total value it was supposed to pay for the companies was approximately \$617,333. It actually only paid US\$190,000 for the share purchase as set out in paragraph 14.3 below. This hardly represents a significant investment and certainly casts considerable doubt on the claim that the value of the assets of TNG amount to over 2.3 billion dollars.
- (b) Further the Claimants present no evidence that either Gabriel Stati, Anatoli Stati, Ascom or Terra Raf had any financial involvement in the transactions at all.
- (c) Rather it appears from the consolidated accounts of TNG, KPM and their group company Tristan Oil that the true investor is Tristan Oil, a party whose participation in these proceedings is barred by its nationality as a company domiciled in the British Virgin Islands (see further 14.11).

9.31 As for the post-acquisition investment made by any of the investors in any of the alleged assets (not simply the Contracts or KPM and TNG), the Claimants are also put to proof that this was significant or valuable. The following is noted and expanded on further at Paragraph 14 and 15 below:

- (a) The Claimants have provided no evidence that they invested over US\$1 bn into the respective companies as stated in paragraph 6 of the SoC.
- (b) In relation to the LPG:
 - (i) Whilst the Claimants assert that they invested USD245 million in the development and construction of the LPG Plant, the article exhibited at C-187 suggests only USD176.5m had been invested.

- (ii) In any event, significant investment in the LPG plant was made by Vitol, an unconnected party (and in this respect, Vitol has interests in the products produced by the LPG Plant.)
- (c) In relation to the Contract 302 Properties (which form the greater part of the Claimants' claim):
 - (i) As set out above, TNG have failed to demonstrate any ownership over any interest in the properties.
 - (ii) In any event, as set out in Part IV (Quantum) and in particular at paragraph 130 of the GCA Report, the value of these properties has not been proven by the Claimants.
 - (iii) Even on the estimation of their own experts, a further 129 well bores would be required to exploit this area (FTI Report, pages 5-6) at a cost of between \$619,751,664 and \$699,115,666 based on the Claimants' assessment of the drilling cost per well at 2008 prices (FTI report, page 93). The amount of any investment made appears to greatly differ from the amounts invested, even if proven.

No ownership or control by a qualifying investor over the alleged investments

- 9.32 In any event, the Claimants have failed to demonstrate the necessary link between the alleged investors and the investments. If it is alleged (to which the Claimants are put to proof) that Ascom "owned" and / or "controlled" KPM and that in relation to TNG, it is assumed that Anatolie Stati "owned" and / or "controlled" TNG through Terra Raf, the Republic has the following observations.
- 9.33 In relation to Ascom's equity interest in **KPM**:
- (a) the Claimants have failed to demonstrate how Ascom has made an investment "*in the Area*" of the Republic either by a 100% shareholding or otherwise. The Claimants have not provided the SPA relating to the initial acquisition of a 62% interest in KPM by Ascom in December 1999 and the further acquisition of the remaining 38% interest in 2004.
- 9.34 In relation to Terra Raf:
- (a) The Claimants have asserted but failed to prove that Terra Raf is 50% owned by Anatolie Stati and 50% by Gabriel Stati. No information on Anatolie Stati's or Gabriel Stati's ownership of the company has been given.
- 9.35 As set out more fully in paragraph 13, the Claimants have therefore failed to prove that either of them directly or indirectly owns or controls any of the Investments.

Principle of Good Faith

9.36 Paragraph 1 of Article 38 of the Statute of the UN International Court of Justice (**Exhibit R-26**), provides that the following are the key sources of international law:

"a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;

b. international custom, as evidence of a general practice accepted as law;

c. the general principles of law recognized by civilized nations;

d. subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law."

9.37 Good faith is a general principle of law applied by the International Court of Justice.⁷⁹

9.38 The principle of good faith was established as one of the fundamental principles for the fulfilment of obligations under international law, pursuant to paragraph 2 of Article 2 of the UN Charter:

"2. All Members, in order to ensure to all of them the rights and benefits resulting from membership, shall fulfill in good faith the obligations assumed by them in accordance with the present Charter." (Exhibit R-28).

9.39 Under the law of international treaties, the principle of good faith requires that agreements must be kept - "*pacta sunt servanda*." It is formulated in Article 26 of the VCLT (**Exhibit C-203**):

"Every treaty in force is binding upon the parties to it and must be performed by them in good faith."

9.40 Article 31(1) of the Vienna Convention on the Law of Treaties of 1969 established the need to interpret the treaty in good faith:

"A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." (Exhibit C-203).

9.41 In accordance with Article 1.7 of the Principles of International Commercial Contracts of 1994 (**Exhibit R-29**):

⁷⁹ In its decisions on matters related to nuclear tests the International Court of Justice declared: one of the basic principles governing the creation and fulfilment of legal obligations irrespective of their sources is the principle of good faith (Cm. Malcolm N. Show. International law. Sixth edition. – Cambridge University Press, 2008, p.104 (**Exhibit R-27**))

"(1) Each party must act in accordance with good faith and fair dealing in international trade.

(2) The parties may not exclude or limit this duty."

Definition of the principle of good faith

9.42 Although the principle of good faith is a general principle of law, it does not have a clear-cut definition and is to be assessed on a case-by-case analysis. That said, in international law, as a minimum, this principle operates to limit other principles of law since any law must implicitly require good faith to not be abused.

9.43 An analysis of general principles of international legal practice and the doctrine suggests that an investor's behaviour is not considered to be in good faith if it:

- (a) does not comply with local laws and contracts concluded by the Investor (specifically the local law and the concluded contracts upon which the legitimate expectations of the Investor are based, subject to the protection of international law);
- (b) does not correspond to social and moral requirements (for example if in violation of public order and justice); or
- (c) does not respect the rights of counterparties and other participants in civil commerce (the equal status of the parties).

9.44 Exploitation of legal rights in violation of the principle of good faith is regarded as abuse of such rights.

Arbitration under ECT claims and the principle of good faith

9.45 The objective of investment arbitration is to find an appropriate balance between two equally legitimate and important interests: the protection of private rights of the Investor and legitimate public interest of the receiving State.

9.46 In several cases arbitrated under the ECT, there has been an evaluation of the proper behaviour of the parties by reference to principles of good faith. A particularly relevant case (notwithstanding they were heard under the International Centre for Settlement of Investment Disputes (ICSID) is "*Phoenix v The Czech Republic*" (Phoenix Action Ltd v Czech Republic, Award, ICSID Case No ARB/06/5) (**Exhibit R-31**).

9.47 In *Phoenix*, the arbitral tribunal noted that the claimant carried out an "investment" not for the purpose of participating in economic activities, but for the sole purpose of bringing international litigation against the Czech Republic. The alleged investments were made solely in order to give the claimant a platform to become involved in international legal activity against the respondent

state (the sole purpose of the "*investment*" was to transform a previously existing national dispute into an international dispute to be resolved by arbitration in ICSID under a bilateral agreement on investment protection). In the opinion of the arbitral tribunal such conduct indicated that the investments had not been made in good faith, and were accordingly not subject to protection.

Evidence indicating that the Claimants have not proved that they made a bona fide investment

- 9.48 The President of the Republic of Moldova, President Voronin, in a letter to the President of the Republic of Kazakhstan, President Nazarbayev on 16 October 2008 (**Exhibit C-8**) drew attention to Mr Anatolie Stati's misconduct (see the second paragraph of the Russian version of the letter; the English translation is incorrect).
- 9.49 It is noteworthy and unusual that the Claimants' misconduct was acknowledged at such a high political level.
- 9.50 As summarised below, there is no evidence that the Claimants have made an investment in good faith. The burden remains on the Claimants to demonstrate that this is satisfied in order to establish that their entitlement to protection under the ECT. Notwithstanding this, in assessing whether or not qualifying investments have been made, the Arbitral Tribunal should be aware of the following evidence which suggests that the Claimants' have not acted in good faith:
- (a) Firstly, in the Claimants' activities in the territory of the Republic of Kazakhstan, which have been found to be in contravention of domestic legislation; and
 - (b) Secondly, in acts contrary to the public order of the Republic of Kazakhstan, as well as requirements of justice:
 - (i) financing out of the money earned in the Republic of Kazakhstan of illegal military groups;
 - (ii) organising civil unrest out of the earned money, in the territory of Moldova and intervention into the internal affairs of the state;
 - (iii) deceit of the participants of civil turnover for the purpose of unilateral profit earning;
 - (iv) provocative actions with the view to escaping responsibility;
 - (v) unlawful gathering of evidence;
 - (vi) submission of false data to the court;
 - (c) third, engaging in activity contrary to the principle of fairness:

- (i) ignoring principles of "*estoppel*", prohibiting reliance on evidence that had previously been denied in order to support claims;
 - (ii) deliberately exaggerating the amount of claims.
- (d) fourth, disregarding of the principle of equal rights of parties in the process.

Illegality of the Claimants' activity in the Republic of Kazakhstan

- 9.51 As set out in paragraphs 4.9 to 4.12 of this Statement of Defence, the main purpose of the ECT is to establish a common framework for the assurance of the rule of law in the energy sector. The ECT should be interpreted in accordance with the objective of respecting for the rule of law, such that the basic means of protection provided by the ECT should not apply to investments that are carried out in violation of the law. (**Exhibit R-32**)
- 9.52 The ECT protects the legal expectations of those investors who qualify for protection under its terms. In the present case those expectations are subject to the terms proposed by the Republic (in the law and the contract on the use of subsurface resources) and accepted by the Claimants when they allegedly began investing in the Republic.
- 9.53 The Claimants' illegal activities in the territory of the Republic suggest that any investments they made were not made bona fide.
- 9.54 The illegality of the Claimants' activity is demonstrated by the following:
- (a) The Claimants unlawfully acquired shares of KPM and TNG (see paragraph 13.1 to 13.23 and 13.27 to 13.29 below);
 - (b) The reorganization of JSC KPM and JSC TNG into limited liability partnerships was illegal (see paragraph 13.24 to 13.26 and 13.33);
 - (c) KPM was illegally engaged in activity involving use of subsurface resources without a licence (see paragraph 13.48 to 13.63);
 - (d) TNG was illegally engaged in activity involving use of subsurface resources without a licence (see paragraph 13.48 to 13.63);
 - (e) The activities of KPM and TNG in the transportation of oil and gas outside the Republic were illegal, as the contract required a license to use the trunk pipeline⁸⁰, which the Claimant did not have (see paragraph 25 below). The Claimants were aware of the need

⁸⁰ In its Statement of Claim, the Claimants refer to "main" pipeline. The Republic regards "trunk" pipeline to be the appropriate reference and therefore refers throughout to "trunk" pipeline notwithstanding that the Claimants' reference to "main" pipeline

to obtain this licence, and even applied for it, but it was refused. It then decided to illegally operate the KPM pipeline;

- (f) In the course of its activities in the territory of the Republic, the Claimants failed to pay legally imposed taxes, as well as penalties it incurred as a result (paragraph 30 below); and
- (g) During the Claimants' activities, there were repeated violations of the contracts for use of subsurface resources (**Exhibit R-37**), resulting in their termination by the competent authority in accordance with the provisions of contracts and the law of Kazakhstan (paragraph 31 below).

Financing of illegal militant groups in circumvention of UN sanctions

9.55 According to the available information, the Claimants engaged in a number of activities that are contrary to international law, including:

- (a) financing of illegal militant groups; and
- (b) acting to circumvent UN sanctions.

9.56 The President of the Republic of Moldova wrote in a letter to the President of the Republic of Kazakhstan on 6 October 2008:

"A fact that deserves serious attention is his (Stati's) use of the proceeds from Kazakhstan's mineral resources to invest in areas that are subject to the sanctions from the international community, particularly from the UN, for example - in South Sudan. Such "blood business" is causing serious damage to the image and international reputation of the country providing him the opportunity to earn profits, as well as the businessman's country of origin."

*The President of the Republic of Moldova continued that Stati began to create "a corrupt lobby of supporters to conclude bilateral trade agreements with entities that are subject to UN sanctions" (**Exhibit C-8**).*

9.57 Former General Director of KPM, G.V. Andreyev stated the following in the Response to an appeal sent to the Mangystau Regional Court covering his case against his former employees at KPM (**Exhibit R-34.1**):

"Money received from sales of the produced hydrocarbons and involved at the market under false pretence was directed by A Stati for financing of the activity in the territory of South Sudan."

(...)

"In 2005, A Stati started his activity in the territory of South Sudan under the personal liabilities for financing and delivery of military weapons and equipment to the National Liberation Movement/Liberation Army of Sudan

According to A Stati, he spent about \$400mn for the activities in the territory of South Sudan".

(...)

"Meanwhile, for the purpose of international peace, security and stability in the region, the Security Council of the UN passed resolutions on Sudan No.1590 (2005) dated March 24, 2005, 1547 (2004) dated June 11, 2004, 1556 (2004) dated July 30, 2004, 1564 (2004) dated September 18, 2004, 1574 (2004) dated November 19, 2004, 1585 (2005) dated March 10, 2005 and 1588 (2005) dated March 17, 2005, where the Security Council called all the countries to take necessary measures to prevent sale and delivery of weaponry and any items of material support connected with it including weapons, ammunition, military equipment, transportation vehicles, paramilitary ammunition and spare parts for everything mentioned above, and to take measures for support and observance of the Comprehensive Peace Treaty concluded between the Government of Sudan and National Liberation Movement/Liberation Army of Sudan."

9.58 This allowed G.V. Andreyev to come to the following conclusion:

"So, the Address of the President of Moldova V Voronin dated October 6, 2008 is reasoned and mentioned there circumstances require investigation from the Security Council of the UN and law enforcement bodies of the Republic of Kazakhstan, Russia, Ukraine and Moldova."⁸¹

The "Bonds" Project (from December 2006 to the present)

9.59 Based on information available to the Republic⁸², the Claimants began the "Bonds" project in 2006. Tristan Oil, a company under the control of the Claimants issued three tranches of bonds with a maturity of 1 January 2012 for a total amount of 531 million USD:

- (a) the first tranche was on 20 December 2006 for 300 million USD;
- (b) the second tranche was on 14 June 2007 for 120 million USD;
- (c) the third tranche was on 19 June 2009 for 111.11 million USD.

⁸¹ Exhibit R-34.1

⁸² Exhibit 68 at the FTI Reort page 17 and FTI Report paragraph 3.3 page 17

- 9.60 All bonds were issued at the EURO MTF Market of the Luxembourg Stock Exchange.
- 9.61 According to available information, Tristan Oil issued bonds guaranteed by KPM and TNG, i.e. under guarantees of companies that the Claimants illegally acquired (for the reasons set out in paragraph 13 below), which engaged in the use of subsurface resources and transportation of oil in the Republic of Kazakhstan without a license. It should be noted that the charter capital of each company at the date of issuance of guarantees amounted to USD 50,000 (**Exhibits C-36 and C-39**), for a total bond issue of 531 million USD (i.e., the charter capital of both companies covers 0.018% of the par bond issue).
- 9.62 The expectation was that the money raised by bond issues would be used by the companies *for general and corporate needs*, which would supposedly mean investing in the use of subsurface resources.
- 9.63 Information regarding the complex nature of the groups' financial arrangements are set out at Exhibit R-37. To the extent that the system set up had the effect of diverting money from Kazakhstan to elsewhere, this is contrary to the objectives of the ECT and indicates a lack of good faith on the part of the Claimants.
- 9.64 As the former General Director of KPM, G.V. Andreyev stated in the explanation sent to the Almaty City Appellate Court (**Exhibit R-34.2**): *“Activities of legal entities are regulated by the civil laws providing protection of rights of both the legal entity and rights and legal interests of the state and third parties.*

The Kazpolmunai LLP is managed by the owner in violation of the requirements of Articles 33, 36, 37, etc. of the Civil Code of the Republic of Kazakhstan.

The Company participates in the illegal financial scheme used for misappropriation.

The Company is not managed by its executive body but by its owner directly from Moldova. All the decisions are not made by the bodies of the legal entity but by the persons authorized by the owners coordinators) extralegally and out of the rules of the Company.”

- (a) Incitement to retaliatory action

Project Zenith

- 9.65 62% of shares in KPM were obtained by the Claimant for free. Under the Articles of Incorporation the Claimant should pay to the company TOO⁸³ “Aksai” 1,500,000 US Dollar as well as make investments in accordance with the work program. Neither the first nor the second obligations

were fulfilled by the Claimants (**Exhibit R-38**). Information about the cost of the purchase of the remaining 38% of shares is missing. 100% of shares in TNG were acquired for approximately USD 190,000 (**Exhibit R-39**).

- 9.66 Acquisition of shares led to the ownership of the companies. However such ownership was illegal. Besides the Claimant carried out the activity for subsoil use and oil transport which was subject to licensing without duly executed licenses (see paragraph 13.48 to 13.66 below). In this situation the Claimants could not carry out ordinary economic activity as the Investor. It could also not legally sell the business as part of Project Zenith.
- 9.67 To implement the projects the Claimants hired the investment company "Renaissance Capital".
- 9.68 As set out in paragraph 16 below the Claimants had considerable difficulty with selling its investment, particularly after it gave potential buyers access to the dataroom when they presumably discovered the extent of the illegalities KPM and TNG were embroiled in (see paragraph 13 below).
- 9.69 It is particularly interesting to note the reasons why JSC EP "KazMunaiGas" withdrew from the bidding process (see letter from KMG ZPJ JSC to KMG NC ISC dated 21 October 2011). In summary, the reasons were:
- (a) TNG and KPM had dramatically increased the amount of extraction of hydrocarbon in 2008-2009, which is reflected in the falling reservoir pressure. This could indicate a deliberate action of the shareholder, which could be the result of irreversible loss of much of recoverable hydrocarbons and growth capital expenditures of drilling new wells (each worth \$ 15 million).
 - (b) Casco service company, which realized all service work in the fields and which belongs to Mr. Stati, 2009, redeployed all the capital goods (work-over machines and rigs, drilling rigs, pipe-layers, etc.) to the other assets of the owner, part of the equipment was sold. In the case of purchasing of KPM and TNG, a new owner could take a long time for recovery works.
 - (c) All the information, discovered within the framework of the due diligence is reflected in the techno-economic model, prepared to determine the value of the assets of companies TNG, KPM and Terra Raf.
 - (d) Since the sum of liabilities and risks of companies TNG, KPM and Terra Raf exceeded the value of the business of these companies, i.e. estimated value of these companies is

⁸³ TOO means Limited Liability Partnership

negative, JSC EP KMG decided to withdraw from the acquisition of these companies (**Exhibit R-41**).

“IPO” Project (from December 2007 till March 2009)

9.70 In 2008 the Claimants were planning to place at the London Stock Exchange the shares of the company “Tristan Oil” which was under its control, which needed to be secured with the assets of TNG (by way of transfer of a 100% shareholding in the charter capital of TNG to the company “Tristan Oil”). As set out in paragraphs 13.48 to 13.66 below, TNG lacked subsoil use licenses and the Claimants lacked rights to the assets of this company.

Provocative nature of the Claimants’ activities

(a) Application to the Court of Arbitration as a way to avoid liability to bondholders

9.71 Understanding the complexity of the situation with the bonds and being unwilling to pay interest and repay the amounts received, as well as being threatened with criminal liability in the USA, the Claimants appear opted for arbitral proceedings as a solution to these issues.

9.72 As noted by G.V. Andreyev:

“The economic crisis frustrated plans of A Stati and the only remedy was bringing the situation to termination of the contract and production before the international arbitration court because of impossibility to cover-up misappropriation of money received at the market.” (Exhibit R-34.1)

(b) A conscious violation of the law

9.73 As set out at paragraphs 25.10 to 25.14, KPM admitted that it owned a pipeline and that it did not have a licence to operate such a pipeline. Despite knowing that a licence is required for KPM and TNG to use subsurface resources in the Republic, as well as for using the trunk pipeline, KPM and TNG performed these activities without a licence. The Claimants must have been aware that it would eventually lead to adverse legal consequences for the companies themselves and for their chief officers. Such illegal activities are subject to civil, administrative and criminal liability under the laws of the Republic.

9.74 Since KPM and TNG violated the laws of the Republic, the Republic was compelled to take action under existing law (to demand the rectification of violations already committed, to apply to the court and law enforcement agencies for prevention of violations discovered as a result of conducting audits, etc.). However, KPM and TNG and their chief officers knowingly failed to comply with the requirements of state authorities and court decisions. At the same time, the methods provided by the law of the Republic for peaceful settlement of disputes were completely ignored. Upon termination of Contracts No. 210 and No. 305 at the initiative of the Republic,

these firms refused to rectify the violations they committed and enter into negotiations with the competent authority in accordance with the procedure provided in Article 72 of the Law “On Subsoil Resources” 2010 (this procedure allowed for negotiation over the course of a year and the reinstatement of the contracts) (**Exhibit R-152**). Instead and as set out in detail at paragraphs 31.158 to 31.165 the Claimants initiated arbitral proceedings ninety days after the alleged expropriation.

- 9.75 Further the evidence tends to suggest that the Claimants provoked problems within the Republic. By way of example, it is appropriate to refer to extracts from a letter written by the Claimants after the Kazakh authorities denied it permission to transfer shares to LLP KPM and LLP TNG (**Exhibit C-41**).

“Therefore, if the state, represented by the Ministry of Energy and Mineral Resources of RK insists on the unlawful, repeated application of LLP Tolkyneftegaz for the issuance of the relevant permit, under which the state would use its pre-emptive right to acquire stakes (shares) in LLP Tolkyneftegaz owned by TERRA RAF TRANS TRADING LIMITED, then LLP Tolkyneftegaz and its sole member will be willing to re-apply for the issuance of a permit in exchange for the government of the Republic of Kazakhstan’s payment to TERRA RAF TRANS TRADING LIMITED of the market value of a 100% stake in the amount of 1.347 billion (one billion three hundred forty-seven million) USD as compensation for TERRA RAF TRANS TRADING LIMITED’s divestiture of a 100% stake in LLP Tolkyneftegaz and for the potentially unsuccessful entrance of TERRA RAF TRANS TRADING LIMITED on the London Stock Exchange through an IPO, on the basis of permits from 26 December 2007. In this case, LLP Tolkyneftegaz’s re-application reached the competent authority after the above-mentioned amount was received by TERRA RAF TRANS TRADING LIMITED. In our opinion, it would be a fair solution in order to resolve the current situation.”

9.76

- (1) In this letter, the Investors provocatively issues an ultimatum to the Republic, without any intention of discussing the matter. The Claimants appear to expect that the result of this letter will be retaliatory actions from the Republic. Rather than being the hapless victims of the Republic’s actions, these examples tend to suggest a more aggressive stance, towards the Republic. Criminal prosecution of Mr. Cornegruta and his disappearance from the Republic of Kazakhstan

- 9.77 When the situation escalated, all of the chief officers of KPM and TNG left the territory of the Republic, taking all of the documents and seals with them, and leaving many questions unresolved.

- 9.78 So, under this order, documentation of the enterprise necessary for execution of the statutory activity was stolen and the labor collective is abandoned. (**Exhibit R-34.1**).
- 9.79 Of the main officers, only the General Director of KPM, Mr. Cornegruta, remained in the Republic. A criminal case was initiated against him, and he received a prison sentence as a consequence. Despite being convicted by a Kazakh court it appears that Mr Cornegruta was able to escape from prison having bribed officials and subsequently disappeared from Kazakhstan (**Exhibit R-169**).
- 9.80 The apparent ease with which Mr Cornegruta fled Kazakhstan despite having been convicted of a crime begs the question why he didn't flee beforehand. The Republic speculates that Mr Cornegruta may all along have been the patsy to the Claimants' plan, his trial and conviction having being provoked in order to sensationalise the Claimants' claims in this arbitration.

Submission of false information

- 9.81 The Claimants repeatedly used false information in the statement of claim. As an example, in paragraph 8.58 above, the statement of claim (paragraph 32) indicated that Anatolie Stati and G. Stati hold a 50% stake in the company Terra Raf Trans Trading Co., Ltd.. This statement is specified with a reference citation 56, which refers to Exhibit C-32. However, Exhibit C-32 does not contain any information about Anatolie Stati and G. Stati owning 50% of the company. Furthermore, Exhibit C-33 lists two British companies as the founders of Terra Raf Trading Ltd. (on pages 6, 15) (Southbirdge Services Limited and Crestmount Services Limited). The Claimants do not present a single document that demonstrates its relationship to the two companies mentioned.

Ignoring the principle of "estoppel", which is one of the general principles of law

- 9.82 The principle of "estoppel" prohibits denial of what had previously been admitted. KPM applied for a license to operate a trunk pipeline (**Exhibit C-115**). Its application was denied. After this, they use the trunk pipeline without a licence and claim (in the lawsuit) that a licence is not necessary.

Statement of false losses in order to strengthen its position in respect to bondholders

- 9.83 The Claimants demands an amount of losses (including interest) that are not within any reasonable limits. For a business that they purchased for only USD 190,000, and that they operated illegally throughout the entire period of existence, the Claimants demand from the Republic an amount close to USD 5 billion. This is completely misconceived given the fact that a business operating without a license in a field involving the use of subsurface resources for such use is not worth anything.

Lack of Evidence

- 9.84 As set out above, there are established international legal rules on the burden of proof.
- 9.85 With a few exceptions, the Claimants' claim is not well-supported. Rather they built a case on the presumption of guilt of the Republic of Kazakhstan. According to the Claimants, the Republic's actions are "quasi-medieval" and "Orevellian" (paragraph s9 and 166 of the SoC) between investor and first State. This is a far from "appropriate" balance. It appears that the intention of the Claimants is and has been to set at the starting point of an analysis that any action by the authorities of the Republic is equivalent to expropriation, such that whether or not taken in accordance with the law is irrelevant. The Claimants ignore that the law of the Republic is relevant must be applied in this case and has been applied. By taking it to its logical conclusion, the Claimants' argument that the requirements of the national law of the Republic should be ignored, the position is that the Claimants believe that they can behave in the Republic as they please, and that any rejection of such conduct by the Republic, even if the Claimants' conduct is in flagrant violation of the Republic's law, should be regarded as expropriation.
- 9.86 Accordingly, the Claimants fail to recognise that the ECT only protects the legitimate expectations of investors, in other words - expectations arising from compliance with national laws. So notwithstanding the other serious examples raising doubt on the Claimants' good faith:
- (a) KPM's General Director was criminally prosecuted in accordance with the law of Kazakhstan for illegal business activities, while sanctions were imposed against KPM. The Claimants state that this is an act of expropriation, without analyzing criminal liability under the law of the Republic (see paragraph 27 below).
 - (b) KPM failed to pay the taxes established and imposed under the laws of the Republic of Kazakhstan. When prosecuted they refused to pay penalties. The Claimants now claim that this amounts to expropriation, forgetting that taxes are universal (see paragraph 30 below).
 - (c) KPM and TNG violated the contract for use of subsurface resources. KPM and TNG were warned, and then, in accordance with the law of the Republic, the contract was terminated. As a consequence, the Claimants accuse the Republic of expropriation. But it must have known that under the law of the Republic, the termination of the contract for use of subsurface resources was one of the available sanctions. Further, such termination is not conclusive in nature. During the course of the year, KPM and TNG were entitled to enter into negotiations to seek to have the contract reinstated (see paragraph 31 below).
- 9.87 Yet still, the Claimants assert that the Arbitral Tribunal should turn a blind eye to these basic transgressions of law and allow the Claimants to enjoy the benefits of the ECT.

10 Kazakh law is relevant and applicable

10.1 The Claimants argue that Kazakh law is “irrelevant” to this dispute, arguing that the only applicable law is international law. This is clearly incorrect as a matter of principle and as a matter of the interpretation of the relevant legislation and applicable rules.

10.2 As the Claimants acknowledge, both Article 22 of the SCC Rules and Article 26(6) of the ECT⁸⁴ are relevant here. Under the ECT, article 26(6) expressly states that three sources of law are applicable, namely the applicable rules, principles of international law and the ECT itself. The applicable rules in turn allow the Arbitral Tribunal to apply those law or rules which it “*considers most appropriate.*”

Kazakh Law

10.3 Kazakh law will be highly relevant to the key issue of whether there is a qualifying investment by the Claimants in accordance with Kazakh law.

10.4 Furthermore Kazakh law is central to the legitimacy of the investigation and the prosecution of KPM and TNG which underpin the Claimants claims in respect of:

- (a) indirect expropriation;
- (b) breach of the Fair and Equitable Treatment standard;
- (c) impairing the Claimants’ investment by unreasonable and discriminatory measures;
- (d) failing to provide an effective means of asserting claims and enforcing rights against the Republic; and
- (e) failing to provide the most constant protection in respect of the Claimants’ investment.

10.5 Kazakh law is also fundamental to the question of whether KPM’s and TNG’s contracts were terminated in accordance with Kazakh law, which underpins the Claimants’ claims in respect of:

- (a) direct expropriation; and
- (b) failure to observe contractual obligations concerning the Claimants’ investments.

10.6 Further, in accordance with Article 1 of the ECT⁸⁵:

" 6)"The Investment" means every kind of assets owned or controlled directly or indirectly, by the investor , and includes:

f) any right conferred by law or by contract or by virtue of any licenses and permits issued pursuant to the law to conduct business in the energy sector."

- 10.7 Based on the above, when considering Investments in the form of the right to use the subsurface resources, the governing laws are the legal provisions of the Republic, as well as licenses, permits and contracts for use of subsurface resources.
- 10.8 In accordance with the contracts for the use of subsurface resources the law of the Republic is the applicable law, as well as international law (paragraph 27.1 of Contract No. 305, paragraphs 22.1 and 22.2 of Contract No. 302 and paragraphs 22.1 and 22.2 of Contract No. 210).
- 10.9 In these contracts the Contractor undertakes to comply with laws of the Republic. This includes the Constitution of the Republic, acts of the President of the Republic, the Kazakh Parliament and the Government and other bodies of the Republic.

Inconsistency of the Claimant's position in respect of the national law of Kazakhstan

- 10.10 The Claimants' own position in relation to the applicability of national law is contradictory. On the one hand they assert that it is not applicable or relevant, and on the other, in respect of the umbrella clause, they note its importance.
- 10.11 At paragraph 370 of the Statement of Claim, the Claimants rely upon the so-called "umbrella" clause. The Claimants assert that the "umbrella" clause provides for performance by the Republic of not only obligations arising out of investment contracts, but also of the obligations arising put of national laws and other statutory acts.
- 10.12 At paragraph 371 of the Statement of Claim, the Claimants point to the violation by the Republic of statutory acts of the Republic.
- 10.13 It is not quite clear how this correlates with the Claimants' assertion in paragraph 242 of the Statement of Claim to the effect that the law of the Republic shall not be applied, in this case. Paragraph 242 of the Statement of Claim reads: "*legislation of Kazakhstan shall not be applied in this dispute as the law...*" In our opinion, the Claimants position is contradictory and self-defeating, and merely demonstrates the importance of national law in this context.

11 Non-admissibility of certain of the Claimants' claims pursuant to the ECT

- 11.1 For the reasons set out below, the claim should be regarded as non-admissible by the Tribunal as:

⁸⁴ Exhibit C-1

⁸⁵ Exhibit C-1

- (a) Pursuant to paragraph 2 of Article 18, the ECT "*shall in no way prejudice the rules in Contracting Parties governing the system of property ownership of energy resources*". This applies to all articles of the ECT, including Article 26 which concerns the dispute resolution procedure.
- (b) This includes issues which relate to the ownership of the energy resources set out in Articles 18(3) and 18(4) of the ECT.
- (c) All of the actions the Claimants allege that the Republic undertook, which the Claimants state breached Articles 10 and 13 of the ECT, relate to the "*system of property ownership of energy resources*". Therefore, the claim is inadmissible, pursuant to paragraph 2 of Article 18 of ECT.

Inadmissible claims pursuant to Article 18 of the ECT

- 11.2 Pursuant to Article 26 of ECT, disputes relating to a breach by a Contracting Party (i.e. a state that is a party to the ECT) of its obligations under Part III of the ECT ("Promotion and Protection of the Investments") can be the subject of a dispute in accordance with the terms of Article 26.
- 11.3 The Claimants have alleged that the Republic was in breach of Article 10 (Promotion, Protection and Treatment of Investments) and Article 13 (Expropriation) of the ECT which fall within part III of the ECT.
- 11.4 The Arbitral Tribunal's ability to consider these claims is limited by Article 18, paragraph 2 of the ECT, the English version of which provides:

*"the Treaty shall in no way prejudice the rules in Contracting Parties governing the system of property ownership of energy resources."*⁸⁶
- 11.5 Examination of provision of paragraph 2 Article 18 of the ECT (concerning the correlation between the ECT provisions and national rules governing the system of property ownership of energy resources) in the Russian language is of principal importance.
- 11.6 Paragraph 2 Article 18 of the ECT in the Russian language reads as follows:

«Без ущерба для целей содействия доступу к энергетическим ресурсам, а также их разведке и разработке на коммерческой основе, Договор никоим образом не затрагивает нормы Договаривающихся Сторон, регулирующие систему владения собственностью на энергетические ресурсы» ("Without prejudice to the objectives of promoting access to energy resources, and exploration and development thereof on a commercial basis, the Treaty shall in no way affect the rules of

the Contracting Parties governing the system of property ownership of energy resources”).”

- 11.7 As we see, in the Russian text the expression “*shall in no way affect*” is used, which means “*shall in no way concern*”; “*shall not extend to*” (in the Russian language the word “*affect*” means “*concern smth.*”, “*extend to smth.*”).
- 11.8 As set out above, in the English language of this provision the expression “*shall in no way prejudice*” is used, which literally means “*does not impair*” or “*does not infringe upon*”.
- 11.9 Thus, in contrast to the English text the provision of paragraph 2 Article 18 of the ECT in the Russian language has a more narrow meaning.
- 11.10 According to Article 50 of the ECT the Russian and English texts are equally authentic.
- 11.11 In case of difference of authentic texts of the treaty one should be guided by article 33 of the 1969 Vienna Convention on the Law of Treaties.
- 11.12 Paragraph 4 Article 33 of the 1969 Vienna Convention on the Law of Treaties sets forth the following:
- “...when a comparison of the authentic texts discloses a difference of meaning... the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted”.*
- 11.13 Thus, the Russian text of paragraph 2 Article 18 of the ECT shall apply in the present case as more narrow by its meaning and reconciling both texts and namely, the ECT shall not apply to the provisions of national legislation governing the system of property ownership of energy resources.
- 11.14 Thus, the following conclusion can be made from the Russian text of paragraph 2 Article 18 of the ECT: Article 26 does not extend to issues related to property ownership of energy resources.
- 11.15 Based on this, Article 18 paragraph 2 of the ECT makes clear that the provisions of the ECT, will not apply in relation to questions/issues concerning a state’s rules governing the system of ownership for energy resources. This would include:
- (a) Disputes commenced pursuant to Article 26; and
 - (b) Claims by an Investor that a Contracting Party (a State) is in breach of Articles 10 and 13 of the ECT.

⁸⁶ Exhibit C-1

11.16 Paragraphs 3 and 4 of Article 18 of the ECT provide guidance on what forms part of the rules governing the system of ownership of energy resources.

Article 18(3)

11.17 Paragraph 3 of Article 18 provides:

“Each state continues to hold in particular the rights to decide the geographical areas within its Area to be made available for exploration and development of its energy resources, the optimalization of their recovery and the rate at which they may be depleted or otherwise exploited, to specify and enjoy any taxes, royalties or other financial payments payable by virtue of such exploration and exploitation, and to regulate the environmental and safety aspects of such exploration, development and reclamation within its Area, and to participate in such exploration and exploitation, inter alia, through direct participation by the government or through state enterprises.”⁸⁷

11.18 Based on this, as part of a State’s rules for governing the ownership of the energy resources, it has the right to:

- (a) determine the allocated areas for exploration and development;
- (b) resolve questions regarding optimalization of production;
- (c) define the rate of the development or exploitation;
- (d) establish and manage any taxes, royalties and other financial dues with respect to such exploration and mining;
- (e) regulate all aspects of environmental protection;
- (f) regulate safety aspects of the exploration and development; and
- (g) participate in the exploration and mining.

Article 18(4)

11.19 As set out in paragraph 4 of Article 18:

“The Contracting Parties undertake to facilitate access to energy resources, inter alia, by allocating in a non-discriminatory manner on the basis of published criteria

⁸⁷ Exhibit C-1

authorizations, licences, concessions and contracts to prospect and explore for or to exploit or extract energy resources.” [emphasis added]

- 11.20 It can be seen from this paragraph and Article 18(2), that facilitating access to energy resources through, inter alia, licenses and contracts, forms part of the system of property ownership as:
- (a) It is pursuant to such licences and contracts that the investor is given the right to exploit land/territories within a particular State and therefore the ‘property’ of that State.
 - (b) Article 18 as a whole concerns the sovereignty over energy resources and a State’s right to govern the system of property ownership over natural resources. Therefore the reference to licenses and contracts being granted to exploit or extract such energy resources within a State’s territory (pursuant to Article 18(4)) can only concern a State’s right to govern that system of property ownership vis-a-vis the granting of licences and/or contracts.
 - (c) Therefore, the terms of the ECT should not impact on issues concerning the licenses and contracts which give the investors such rights.
- 11.21 The Claimants consider themselves to be investors on the grounds that the two companies they allegedly own in Kazakhstan (KPM and TNG) have licences and contracts to explore and exploit energy resources in Kazakhstan:
- (a) License MG 309-D effective from 27 March 1996 and Contract No. 305, dated 30 March 1999 (which was concluded on the basis of the license);
 - (b) License MG No.242-D effective from 4 December 1997 and Contract No.210, dated 12 August 1998 (which was concluded on the basis of the license); and
 - (c) License MG No.243-D effective from 4 December 1997 and Contract No. 302, dated 31 July 1998 (which was concluded on the basis of the license).
- 11.22 Under the Kazakh law which was applicable at the time⁸⁸ when the licences and contracts were entered into, a subsoil user only had a right to exploration and extraction as per the terms of the license. The Contracts were executed pursuant to the licenses.
- 11.23 Contracts 210 and 305 were executed for the purpose of exploration and extraction of hydrocarbons⁸⁹ and, in broad terms, have similar provisions. Contract 302 was executed solely

⁸⁸ See paragraphs 13.48 to 13.63 below

⁸⁹ See: **Exhibit C-45** Contract clause 2 and Licence clauses 2 and 5; **Exhibit C-52** Contract clauses 2 and 3 and Licence clauses 2 and 5

for the purpose of exploration of hydrocarbons⁹⁰, and also has similar contents to the other contracts.

- 11.24 Pursuant to the terms of the licenses and the contracts, KPM and TNG were given the right to both explore and exploit a subsoil area (i.e. a specific territory in the Republic) for a certain period of time within that defined subsoil territory.⁹¹ This is directly relevant to the system for property ownership as the Republic effectively granted these companies rights over its land/territory.
- 11.25 In exchange for that right in relation to the Republic's property, KPM and TNG had certain obligations including:
- (a) The obligation to carry out its exploration and/or exploitation activities on the basis of a Work Program which determines the minimum scope of work to be carried out (in pecuniary and physical terms) within certain established time periods.⁹²
 - (b) Other contractual obligations in favour of the Republic, including the obligation to engage Kazakh subcontractors, train local specialists and employ a Kazakh workforce.⁹³
 - (c) The obligation to make payments in exchange for exploring and/or exploiting the land in accordance with the legislation of the Republic of Kazakhstan and the terms of the contract, including the payment of taxes, royalties etc.⁹⁴
 - (d) The obligation to comply with Kazakh law and subsoil use legislation as a whole.⁹⁵
- 11.26 A breach of the terms of the license, contract and subsoil use legislation could lead to sanctions including statutory disciplinary liability, liability for damages and administrative and criminal liability (including punitive sanctions and penalties for a breach of tax legislation).⁹⁶ The right to sanction a subsoil user for breaching its rights to explore and exploit the Republic's property would form part of the system of property ownership.
- 11.27 Furthermore, the state authorities of Kazakhstan are entitled to exercise control over the activity of the Contractor (in accordance with the legislation of the Republic of Kazakhstan)⁹⁷, which

⁹⁰ See **Exhibit C-53** Contract clauses 2 and 3 and Licence clauses 2 and 5

⁹¹ See: **Exhibit C-45** Contract clause 2 and Licence clauses 2 and 5; **Exhibit C-52** Contract clauses 2 and 3 and Licence clauses 2 and 5; **Exhibit C-53** Contract clauses 2 and 3 and Licence clauses 2 and 5

⁹² See: **Exhibit C-45** Contract clause 8.1; **Exhibit C-52** and **Exhibit C-53** Contract clause 7

⁹³ See: **Exhibit C-45** Contract clauses 7.2.9 and 7.2.11 and Licence clauses 9.1-9.3; **Exhibit C-52** Contract clauses 6.2.7-6.2.9 , 6.2.11 , 6.2.12 and 7.8 and Licence clauses 9.1-9.3; **Exhibit C-53** Contract clauses 6.2.7-6.2.9 , 6.2.11 , 6.2.12 and 7.8 and Licence clauses 9.1-9.3

⁹⁴ See: **Exhibit C-45** Contract clause 17; **Exhibit C-52** and **Exhibit C-53** Contract clause 12

⁹⁵ See: **Exhibit C-45** Contract clause 27.1; **Exhibit C-52** and **Exhibit C-53** Contract clause 22.1

⁹⁶ See: **Exhibit C-45** Contract clauses 17.10 and 23.3; **Exhibit C-52** clauses 12.10 and 18.3; **Exhibit C-53** Contract clauses 12.10 and 18.3

⁹⁷ See: **Exhibit C-45** Contract clauses 7.3 and 7.4; **Exhibit C-52** clauses 6.3 and 6.4; **Exhibit C-53** Contract clauses 6.3 and 6.4

again relates to control over the Republic's property and their the system of ownership of that property.

- 11.28 The ultimate sanction under the contracts, licenses and Kazakh law is to terminate the contractor's right to explore and exploit the Republic's land/territory as granted by the licenses and contracts.⁹⁸ This would of course form part of the system of property ownership as it relates to the removal of the right to property, as granted by the state, as a result of contractual and legislative violations.

Non-admissibility of certain of the Claimants allegations

- 11.29 The Claimants have alleged that the Republic took action to both indirectly and directly expropriate the Claimants' investment in Kazakhstan⁹⁹, which it claims was in breach of Articles 10 and 13 of the ECT.

- 11.30 However, for the following reasons the majority of these allegations fall squarely within the Republic's right to govern the system of property ownership for its energy resources and therefore, pursuant to Article 18(2) the Tribunal has no jurisdiction to hear such claims:

(a) Republic's right to audit KPM and TNG (referred to, inter alia, in Section IV A and Section V of the SoC): The Republic's right to audit KPM's and TNG's use of its property (as granted by the Licenses and Contracts) is part of the system for property ownership as:

- (i) As set out above, the authorities of Kazakhstan are entitled to exercise state control over the activities of the contractor, in accordance with the license, contract and the law.
- (ii) This right is reinforced by Kazakh law, which we provide further details of in section paragraphs 19 and 20 below.
- (iii) Consequently, this issue relates to the Republic's right to exercise control over its property and therefore forms part of the subject matter of the system of property ownership under Articles 18(2) and 18(4) of the ECT.

(b) Operation of trunk pipeline (see, inter alia, Section IV B 1 to 4 of the SoC): The Republic's right to decide, inter alia, whether the Claimants were operating a trunk pipeline without a license, commence criminal proceedings against Mr. Cornegruta and

⁹⁸ See: **Exhibit C-45** Contract clauses 30.2 and 30.5; **Exhibit C-52** clauses 25.2 and 25.5; **Exhibit C-53** Contract clauses 25.2 and 25.5

⁹⁹ See sections IV and V of the SoC

KPM and fine KPM for operating such a pipeline is part of the system for ownership over property as:

- (i) As set out above, the Claimants have been given the right to explore and exploit the Republic's land.
- (ii) The operation of pipelines form part of that right to explore and exploit;
- (iii) Failure to comply with the Contracts by operating illegal pipelines and producing oil and gas illegally, can result in sanctions which are provided for in the Contracts and under Kazakh law;
- (iv) This is all part of the Republic's right to govern the system of property ownership over its energy resources by contracts and licenses pursuant to Articles 18 (2) and 18 (4);
- (v) It also forms part of the Republic's right to decide the optimisation of the recovery from exploration and development of energy resources under Article 18(3), which is part of the Republic's right to govern the system of ownership of its energy resources.

(c) Tax Proceedings (see, inter alia, sections III D, E and F of the SoC): The Republic's right to decide and sanction the Claimants in relation to its failure to pay taxes forms part of the system of property ownership as:

- (i) As set out above, in accordance with each of the contracts, the payment of tax and payment of export customs duty was required by the legislation of Kazakhstan, and by the contracts and licenses, which refer to the applicable legislation;
- (ii) Failure to comply with the Contracts by breaching tax law, can result in sanctions which are provided for in the Contracts and under Kazakh law;
- (iii) This is part of the Claimants' obligations to the Republic in exchange for being granted licenses and contracts over its land (Articles 18(2) and (4)); and
- (iv) It is also one of the aspects that the Republic specifically has the right to decide under Article 18(3).

(d) Execution Proceedings (see, inter alia, Section IV B 5 of the SoC): This essentially relates to the Claimants' failure to comply with the requirements of the authorities regarding its payment of fines as a result of it operating a trunk pipeline without a licence. The Republic issued writs of execution and commenced receivership proceedings as a result of the companies failure to pay. This all forms part of the Republic's property ownership rights as:

- (i) As set out above, sanctions for breach of the contracts and licenses is part of the Republic's right to discipline investors that fail to comply with the system of property ownership; and
 - (ii) This is therefore all part of the Republic's right to govern the system of property ownership over its energy resources by contracts and licenses pursuant to Articles 18 (2) and 18 (4).
- (e) Alleged refusal to extend the period of exploration of the fields under Contract 302 (see, inter alia, section IV G of the SoC):** The Republic's right to decide whether a contract or license should not be extended forms part of the system of property ownership as:
- (i) As stated above, the terms in which a subsoil user has the right to carry out exploration activity forms part of the Republic's right to decide how long it will allow a subsoil user access to its land and therefore directly relates to the Republic's right to control property ownership under the ECT.
 - (ii) This issue is directly referred as a right that each state has under Article 18(3) as well as being specified in the licenses and/or contracts to decide under Articles 18(2) and 18(4).
- (f) Direct expropriation see, inter alia, (section V of the SoC):** This concerns the Republic's termination of the Contracts and subsequent transfer into trust management in accordance with Kazakh law, which again forms part of the Republic's right to govern property ownership:
- (i) It relates to the termination of the contracts by the Republic which effectively granted the Claimants rights over its property; and
 - (ii) This falls directly under an issue which the Republic has sovereignty over under Articles 18(2) and (4).
 - (iii) It also forms part of the Republic's right to decide on whether the subsoil area should be considered as being made available for exploration and development of its energy resources under Article 18(3).

11.31 For these reasons the Tribunal does not have jurisdiction to hear any of the claims referred to above, which constitute all of the allegations that have been made, except in relation to the alleged transfer of TNG from Gheso to Terra Raf. This alleged transfer is in any event not relevant as set out in Paragraph 13 below.

PART 3: SUBSTANTIVE MERITS**12 The Claimants' illegal investment in Kazakhstan**

12.1 The Claimants make the following assertions in relation to their investments in the Republic, in sections III, IV C, IV G and IV H of the SoC:

- (a) KPM and TNG were legally acquired and owned.
- (b) They had the right to carry out exploration and/or extraction activities of certain fields pursuant to licenses and contracts they held.
- (c) They invested significant resources in developing the fields operated and assets owned by KPM and TNG.
- (d) Prior to the Republic's alleged "harassment campaign", the companies were worth a considerable amount as a result of the Claimants' investment.
- (e) The Republic took action against the assets owned and fields operated by the companies, as well as against the companies themselves, which had the impact of reducing the companies' value and alienability.
- (f) The Claimants were therefore unable to sell the companies.

12.2 Each of these assertions is denied for, in summary, the following reasons:

- (a) The Claimants' acquisition and subsequent intra-group transfers of KPM and TNG were fundamentally illegal.
- (b) In breach of Kazakh law, KPM and TNG did not have licenses to explore any of the fields which the Claimants had allegedly invested in.
- (c) In any event, the Claimants invested very little in developing each of the assets and fields illegally owned and operated by KPM and TNG.
- (d) Furthermore, the assets and fields were worth far less than what the Claimants state they were and were declining in value for reasons which had nothing to do with alleged actions by the Republic.
- (e) The Claimants therefore failed to attract interest from buyers in the market when it attempted to sell KPM and TNG, who were unwilling to pay the extortionate amounts the Claimants wanted for its illegally owned assets.

13 The Claimants' illegality

(a) Illegal investment in KPM

(i) Background information of the formation of KPM

- 13.1 KPM was established as a closed joint stock company joint venture on 24 March 1997 (**Exhibit C-45**). The companies Polmak Sondazh Sanaii A.Şh. (from the Republic of Turkey) (**Polmak**) and CJSC Joint Kazakh-Estonian-Irish company Aksai (**JSC Aksai**) were the founders (**Exhibit C-45**), and equal 50% owners of the company.
- 13.2 On 23 May 1997, KPM was issued a License for use of subsurface resources MG No. 309-D. The license included the name of the company as well as the date of its establishment (**Exhibit C-45**).
- 13.3 The registration of a legal entities card as of 24 March 1997 (**Exhibit R-9**) shows that the organization was incorporated as a non-commercial organization.

(ii) Illegal formation of KPM

- 13.4 The Arbitral Tribunal should note the following provisions of the Law of the Republic of Kazakhstan of 5 March 1997, No. 77-1, "On the Securities Market" (the **SM Law**) (**Exhibit R-7**) and Civil Code of the Republic of Kazakhstan (**CC RK**) (**Exhibit R-8**) which are important in showing that KPM was not legally established:

- (a) Paragraph 1 of Article 16 of the SM Law states the following:

" A joint-stock company shall submit to a competent authority not later than three months following its state registration as a legal entity a package of documents required for registration of the stock issue".¹⁰⁰

- (b) Paragraph 5 of Article 18 of SM Law¹⁰¹ provides that if the information submitted in the documentation for the issuance of securities is false, inaccurate or incomplete, the issuer and its officials shall be liable.
- (c) Paragraph 1 of Article 17 and paragraphs 4 and 7 of Article 18 of the SM Law¹⁰² provide that within 30 days from the date of presentation of the package of documents, the competent authority will review such documents, carry out the registration of the securities issue with the State Register of Securities Issue of the Republic of Kazakhstan and assign it a national identification number.

¹⁰⁰ Exhibit R-7

(d) Paragraph 2 of Article 17 of the SM Law¹⁰³ provides that securities issues that do not appear in the State Register of Securities Issues of the Republic of Kazakhstan are invalid.

(e) "Issue" pursuant to Article 2 of the SM Law¹⁰⁴, means the issuing of and placement of securities for the purpose of the formation of the charter capital or raising or borrowing of funds. Therefore, the issuing of and placement of securities without state registration of the issue (i.e. without entry of data concerning the issue to the State Register of the Issue of Securities of the Republic of Kazakhstan and, accordingly, without assignment of a national identification number to it) is invalid.

(f) Therefore, transactions involving shares that were issued but not registered in accordance with Kazakh law are invalid.

(g) Under paragraph 8 of Article 157 of the CC RK (**Exhibit R-8**):

"an invalid transaction shall entail no legal consequences, except those which are connected with its invalidity, and shall be invalid from the time of its conclusion."

(h) Therefore, the ownership of such shares is illegal. Paragraph 4 of Article 133 of the CC RK states that:

"the rights under a security which is in possession of an illegal owner are not enforceable". (**Exhibit R-8**)

13.5 KPM was created as a joint stock company joint venture (of JSC, Aksai and Polmak) with participation in the company via foreign capital.

13.6 On the basis of paragraph 1 of Article 16 the SM Law¹⁰⁵ (as amended, and operative in 1997) KPM should have submitted the necessary package of documents to register the issue of securities to the competent authority no later than three months from the date of registration (i.e. no later than 24 June 1997).

13.7 KPM did not submit these documents for registration at the time it was created and therefore KPM was never legally formed.

13.8 Any transfer of shares could only take place after the registration of the issue of securities. As KPM did not register the issue either at the time of creation or when it was purchased by Ascom in December 1999, the shares were never legally transferred to Ascom.

¹⁰¹ Exhibit R-7

¹⁰² Exhibit R-7

¹⁰³ Exhibit R-7

13.9 Based on the above:

- (a) the joint venture companies Polmak and JSC Aksai could not be regarded as legally investing in KPM;
- (b) Ascom could not be regarded as legally investing in the company in December 1999 when it allegedly acquired 62% of KPM from Polmak and JSC Aksai (as to which acquisition the Claimants are put to proof);
- (c) Ascom could not be regarded as legally investing in KPM in December 2004 when it allegedly purchased the remaining 38% of the Shares from JSC Aksai (as to which acquisition the Claimants are put to proof).

(iii) Illegal registration of KPM upon transfer to Ascom

13.10 The Arbitral Tribunal should note that the following provisions of Kazakh law which relate to establishing a joint stock company as a non-commercial organization:

- (a) It is permissible to establish such a company under paragraph 3 of Article 34 of the CC RK (**Exhibit R-8**) and part 2, paragraph 1 of Article 54 of Presidential Decree of 2 May 1995 No. 2255 "On Business Partnerships" (**Exhibit R-10**).
- (b) However, in these circumstances the non-commercial organisation would be subject to the legal regime for joint stock companies in accordance with the laws of Kazakhstan. Specific legislative provisions apply to such non-commercial organisations including that their primary purpose should not be to derive income and they are not allowed to distribute income to their shareholders (paragraph 1 of Article 34 of the CC RK) (**Exhibit R-8**).
- (c) On 10 July 1998, Law No. 281-1 "On Joint Stock Companies" was passed (**JSC Law 1998 (Exhibit R-11)**). Paragraph 5 of Article 3 of the JSC Law 1998 provides that income generated by non-commercial organizations must be used solely for the development of the company.
- (d) Payments of dividends on shares also cannot be made (paragraph 6 of Article 19 of the JSC Law 1998¹⁰⁶), which should be established in the Charter of company (paragraph 2 of Article 13 of the JSC Law 1998¹⁰⁷).

¹⁰⁴ Exhibit R-7

¹⁰⁵ Exhibit R-7

¹⁰⁶ Exhibit R-11

¹⁰⁷ Exhibit R-11

- (e) Furthermore, pursuant to paragraph 6 of Article 97 of the JSC Law 1998 (**Exhibit R-11**), a joint stock company founded as a non-commercial organization cannot be reorganized into a commercial organization.
- 13.11 After Ascom's alleged purchase of a 62% interest of KPM (the legality of which is not accepted by the Republic), on 9 December 1999, should have been named in the revised Articles of Association together with Aksai (the Claimant are put to proof on this).
- 13.12 According to the state registration of legal entities card as of 13 December 1999 (**Exhibit R-12**) KPM was reorganised from non-commercial organization to a commercial organization.
- 13.13 Pursuant to paragraph 6 of Article 97 of the JSC Law 1998 (**Exhibit R-11**), this type of reorganization is illegal.
- 13.14 It is clear therefore clear that the Claimants illegally arranged for the registration of the company to be amended so that:
- (a) It became one of the shareholders; and
 - (b) the word "non-commercial" in the register was changed to "commercial" (**Exhibit R-13**).
- 13.15 Therefore, in addition to the reasons set out above, Ascom should also not be regarded as a legal owner of KPM as it violated Kazakh law when it registered itself as an owner of the company.
- (iv) Illegality of the acquisition of KPM due to failure to obtain the relevant consent***
- 13.16 In accordance with paragraph 1 of Article 53 of the Law of the Republic of Kazakhstan of 28 June 1995, No. 2350 "On Petroleum" (as amended in 2003) (**1995 Petroleum Law**):
- "The Contractor may transfer to another legal or natural person or international organization all or a part of its rights and obligations under the contract, including by way of alienation of the controlling block of stock, only subject to a written approval of the licensing and competent authorities. The conditions of transfer of rights and obligations to a subsidiary company shall be specified in the Contract"* (**Exhibit R-16**).
- 13.17 The article applies to:
- (a) the assignment of rights by a contractor to another party; and
 - (b) the alienation of a controlling share interest by the owner of those shares to another party.

- 13.18 The article provides that the contractor/owner is obliged to obtain written permission of the licensing and competent authorities for the transfer of shares.¹⁰⁸
- 13.19 The licensing authority up until 2003 was the Government of the Republic of Kazakhstan (the Government granted each of the licenses to KPM and TNG) and the competent authority was the MEMR (**Exhibit R-17**).
- 13.20 The Claimants did not obtain consent to the purchase of KPM from either of these two entities. For the avoidance of doubt, the letters it has exhibited to the SoC show only show that it liaised with two other entities (the Agency of the Republic of Kazakhstan on Investments and the Agency on Investments Licenses and Contracts) which were not the licensing or competent authorities.
- 13.21 Therefore, in addition to the reasons set out above, Ascom's purchase of KPM was illegal as it failed to obtain the required consent when it purchased shares in KPM both in 1999 and 2004.

(v) Illegality of any subsequent attempts to remedy failure to obtain consent due to failure to comply with pre-emptive rights of the State

- 13.22 As a result of the various share transfers being illegal for the reasons set out above, any attempts to rectify the issues after December 2004 would have also required the Claimants to apply to the Republic for a waiver from the state of its pre-emptive rights to purchase KPM and TNG as required by 8 December 2004 amendments to the Law "On Subsoil and Subsurface Use" 1996 (**Exhibit R-19**) as amended by Part 3 of art. 71 of the Law "On introduction of amendments and additions to some legislative acts of the Republic of Kazakhstan on questions of subsurface use

¹⁰⁸ In paragraph 142 of the Statement of Claim the Claimant refers not to the law but to paragraph 21.1 of Contract № 302 for subsoil use (**Exhibit C-53**) and Contract № 210 for subsoil use (**Exhibit C-52**).

Paragraph 21.1 of the Contracts are much narrower than paragraph 1 Article 53 of the Law "On Petroleum" (**Exhibit R-16**). Paragraph 21.1 of the Contracts concerns only the transfer of rights and obligations under the contract to a third person (i.e. it does not concern the issues of transfer of shares of the contracting firm). Paragraph 21.1 of the contract sets forth only that the authorization should not be obtained if the rights and obligations under the contract are transferred to a branch or subsidiary company.

Definition of a branch is given in Article 43 of the RK CC:

*«1. A branch is a separate subdivision of a legal person located outside the place of location of the legal person and carrying out all or a part of its functions, including the functions of representation» (**Exhibit R-8**).*

Please note that the term "branch" has no relation to the term "affiliated person".

Definition of a subsidiary company is contained in Article 94 of the RK CC:

*«1. A subsidiary organization is a legal entity **the major part of which charter capital (issued charter capital)** was formed by another legal entity (hereinafter – principal organization) or if in accordance with a contract made between them (or otherwise) the principal organization has the possibility to determine decisions made by such organization (**Exhibit R-8**).*

Thus, in accordance with the contracts it is necessary to obtain approval in all cases, except for a transfer of rights under the contracts to a branch or subsidiary enterprise.

and carrying out petroleum operations in Republic of Kazakhstan” 2004 (the **2004 amendments**) which provides that:

*“the state has priority before the second contracting party or mooters which posses the right of subsurface use or other persons for the purchase of the alienation right for subsurface use (its part) and (or) market share (holding of shares) in the legal person which possesses the right of subsurface use (as well as in the legal person which has the possibility directly and (or) indirectly define decisions and (or) influence the decision of subsurface use in the process of accepting if the main activity of this legal person is connected with subsurface use in the Republic of Kazakhstan) on conditions which are not worse than proposed by other purchasers.” (Exhibit R-20).*¹⁰⁹

13.23 The Claimants’ failed to make this application and the Republic’s rights have not been waived.

(vi) Illegality relating to the attempts to reorganise KPM as a Limited Liability Partnership (LLP) from being Closed Joint Stock Companies (CJSC)

13.24 Pursuant to paragraph 1 of Article 139 of the CC RK, a share is:

“security issued by a joint-stock company and evidencing the rights to participation in the management of the joint-stock company, receipt of dividends on it and a part of the property of the joint-stock company in the course of its liquidation, as well as other rights provided for legislative acts of the Republic of Kazakhstan” (Exhibit R-8).

13.25 For the reasons set out in paragraphs 13.4 to 13.15 above, Ascom did not lawfully acquire shares in KPM, as KPM did not provide the documents necessary to register its securities issue.

13.26 As Ascom did not legally hold shares in KPM:

(a) Ascom was not entitled to manage “the business of the joint stock company”, in accordance with paragraph 1 of Article 139 above (**Exhibit R-8**), which meant that the purported reorganisation of JSC KPM to LLP KPM in 2005 (**Exhibit C-37**) was not effective and Ascom never became a shareholder in LLP KPM; and

(b)

(i) Any investment acquired by Ascom in LLP KPM as a result of the reorganisation was similarly unlawful; and

¹⁰⁹ The Law of the Republic of Kazakhstan dated 14 October 2005 № 79-III (**Exhibit R-151**) extended the right of the State also to transactions for the purchase of a shareholding (block of stock) in a legal entity which has a possibility to determine, directly or indirectly, the decisions and (or) to influence the decisions passed by subsoil users, if the principal activity of such legal entity is connected with subsoil use in the Republic of Kazakhstan.

- (ii) Since JSC KPM ceased to exist upon the reorganisation, it became impossible at that point for Ascom to rectify the underlying illegality in its ownership of KPM in whatever form.

(b) Illegality of investment in TNG

(i) Illegality of the acquisition of TNG due to failure to obtain the relevant consent

- 13.27 For the reasons set out in paragraphs 13.16 to 13.19 above, the Claimants were required under Kazakh law to obtain consent from the Government of the Republic and the MEMR to purchase and subsequently transfer ownership of TNG.
- 13.28 The Claimants did not obtain consent to any of the various share transfers that took place involving TNG:
- (a) the enclosed transaction log of JSC Registrar Zerde (**Exhibit R-18**), shows that a total of 13 transactions were effected with the shares of OJSC TNG in the period since the company was formed. The transfer of a shareholding in a company which amounts to a controlling stake required the written permission of the Government of the Republic of Kazakhstan (as the licensing authority) and the MEMR (as the competent authority), as set out in paragraphs 13.16 to 13.19 above.
 - (b) The register shows that 8 of the 13 transactions (transactions No. 4, 5, 6 and 9 to 13) were acquisitions of a controlling stake, and required such permits.¹¹⁰ This includes:
 - (i) The transfer of 3750 shares (out of 5000) in TNG on 13 March 2002, from Ascom to Gheso (**Exhibit C-55**);
 - (ii) A transfer of 950 shares from LLP Kainar Ltd to Gheso on 30 April 2002 (**Exhibit C-56**);
 - (iii) A transfer of 100 shares from LLP Production-Commercial Firm Dobro to Gheso (**Exhibit C-57**) and 200 shares from LLP Anavi to Gheso on 3 May 2002 (**Exhibit C-58**) which resulted in Gheso becoming the 100% owner of TNG;
 - (iv) The transfer on 12 May 2003 of shares from Gheso's 100% shareholding in TNG to Terra Raf.¹¹¹
- 13.29 The Claimants did not obtain authorisation from the Government of the Republic nor the MEMR for these transfers and therefore they should be regarded as invalid.

¹¹⁰ Exhibit R-18

¹¹¹ Exhibit C-60

(ii) Illegality relating to the attempts to reorganise TNG as a Limited Liability Partnership (LLP) from being Open Joint Stock Companies (OJSC)

- 13.30 For the reasons set out in paragraph 13.27 to 13.29 above, the Claimants have not obtained the relevant consents for the various transfers it was involved in of TNG.
- 13.31 In particular, the Claimants did not obtain the relevant consent required for the transfer of TNG from Gheso to Terra Raf and, for the reasons set out below, did not retrospectively obtain consent to the transfer.
- 13.32 For these reasons, when TNG was reorganised from an OJSC to an LLP in 2005, Terra Raf was not legally a shareholder of TNG and could not therefore carry out its reorganisation from an OJSC to an LLP.
- 13.33 This meant that the registration of TNG as an LLP was illegal as:
- (a) Terra Raf was not entitled to manage “the business of the joint stock company” in accordance with paragraph 1 of Article 139 (**Exhibit R-8**) above, which meant that the purported reorganisation of JSC TNG to LLP TNG in 2005 was not effective and Ascom never became a shareholder in LLP KPM; and
 - (b)
 - (i) Any investment acquired by Terra Raf in LLP TNG as a result of the reorganisation was similarly unlawful; and
 - (ii) Since JSC TNG ceased to exist upon the reorganisation, it became impossible at that point for Terra Raf to rectify the underlying illegality in its ownership of TNG in whatever form.

(iii) The Claimants’ attempts to rectify the various illegalities relating to the transfer of TNG from Gheso to Terra Raf and obtain a waiver of the Republic’s pre-emptive rights

THE REPUBLIC’S POSITION

- 13.34 In their Statement of Claim the Claimants assert that the State had allegedly withdrawn its waiver of pre-emptive right to purchase the participatory share in “Tolkynneftegaz” LLP. These actions allegedly did not allow the Claimants to transfer a 100% share in the charter capital of “Tolkynneftegaz” LLP to the company “Tristan Oil” which, it is understood, was planning to offer its shares at the London Stock Exchange (IPO).
- 13.35 In paragraphs 19, 140-155 of the Statement of Claim the Claimants narrate this story. In order to understand its claims the Republic would like to draw the attention to the following.

- 13.36 In the period concerned the Law of the Republic of Kazakhstan dated 27 January 1996 № 2828 “On Subsoil and Subsoil Use” was in effect. On 8 December 2004 amendments to these Law came into force,¹¹² according to which pursuant to part 3 of Article 71 of the RK Law “On Subsoil and Subsoil Use” the State had acquired under the newly as well as earlier concluded contracts the priority right towards the other party to the contract or the participants of a legal entity possessing the right to subsoil use and other persons to purchase a transferred right to subsoil use (or a part thereof) and (or) a shareholding (block of stock) in a legal entity possessing the right to subsoil use on conditions not worse than that offered by other buyers.
- 13.37 The Law of the Republic of Kazakhstan dated 14 October 2005 № 79-III extended the right of the State also to transactions for the purchase of a shareholding (block of stock)¹¹³ in a legal entity which has a possibility to determine, directly or indirectly, the decisions and (or) to influence the decisions passed by subsoil users, if the principal activity of such legal entity is connected with subsoil use in the Republic of Kazakhstan.
- 13.38 In 2008 the Claimants were planning to place at the London Stock Exchange the shares of the company “Tristan Oil” which was under its control which had to be secured with the assets of “Tolkynneftegaz” LLP (by way of transfer of a 100% shareholding in the charter capital of “Tolkynneftegaz” LLP to the company “Tristan Oil”).
- 13.39 This transaction was illegal, since “Tolkynneftegaz” LLP was established with violation of the legislation. The Claimant had no rights to the property of TOO “Tolkynneftegaz». In any event, “Tolkynneftegaz” LLP did not reissue the licence for carrying out subsoil use operations in the Republic of Kazakhstan.
- 13.40 To make this operation in accordance with the legislation of the Republic of Kazakhstan in force the approval of this transaction, the State’s waiver of its pre-emptive right should have been obtained. The Claimants are put to proof that this was granted to TOO “Tolkynneftegaz”.
- 13.41 The reason for such conduct of the State was the investigation of notification of illegal activity of Stati in the territory of the Republic of Kazakhstan following which the illegality of acquisition by the company “Terra Raf Trans Trading Ltd.” of shares in JSC “Tolkynneftegaz”, illegality of creation of “Tolkynneftegaz” LLP and illegality of its activity (absence of the subsoil use license) as well as violations of contractual obligations were revealed.

¹¹² See the Law of the Republic of Kazakhstan “On Introduction of Amendments and Addenda to Certain Legislative Acts of the Republic of Kazakhstan concerning the Issues of Subsoil Use and Carrying out of Oil Operations in the Republic of Kazakhstan” (**Exhibit R-22**). The amendments were put into effect as of the date of their official promulgation which took place on 8 December 2004 in the newspaper “Kazakh Pravda” (№ 280 (24590)).

¹¹³ See **Exhibit R-151**

13.42 This waiver was aimed at prevention of expansion of illegal operations of the Claimant abroad (in this respect see in more detail paragraphs 2 and 3 of Part I of the Statement of Defence). The Republic of Kazakhstan acted in accordance with its international law obligations which follow from the treaties to which it is a participant (**Exhibit R-115**).

FURTHER ANALYSIS

13.43 In Section IV C of the SoC, the Claimants have tried to argue that the Republic waived its pre-emptive rights to purchase TNG upon its transfer from Gheso to Terra Raf in May 2003 and then sought to revoke that waiver.

13.44 However, based on the analysis above it is clear that:

- (a) Gheso did not obtain the relevant consents it was legally required to for its purchase of TNG and therefore it was not legally able to sell TNG to Terra Raf;
- (b) The transfer from Gheso to Terra Raf was also not legal as the relevant consents were not obtained at the time;
- (c) The Republic was not asked to waive its pre-emptive right to purchase TNG at the time of the transaction; and
- (d) Terra Raf was prevented from obtaining retrospective consent to the transfer or a waiver of the state's pre-emptive right to purchase as a result of the reorganisation of TNG from an OJSC to an LLP.

13.45 For these reasons, Terra Raf was never the legal owner of TNG.

13.46 Notwithstanding this, the Claimants have tried to argue that its subsequent attempts to rectify its various violations of Kazakh law in purchasing TNG were somehow part of the Republic's "harassment campaign" against it (paragraph 140 of the SoC). This is clearly not the case.

13.47 What is instead apparent is that the Republic became concerned that TNG was embroiled in illegality and therefore commenced investigations into the entity (see paragraphs 13.27, 13.33 and 13.48 to 13.63 below). This was completely justified for the reasons set out above. The Claimants have made a number of incorrect assertions to mask this and therefore the Republic provides the following critique of each of the points the Claimants have made with regard to its attempt to rectify its various illegalities:

- (a) As a preliminary point, it should be noted that Kazakh law does not provide that retrospective consent to a transfer can be obtained from the Republic. In any event obtaining consent to transactions involving JSC TNG would have been impossible after JSC TNG became LLP TNG (see paragraph 13.30 to 13.33 above). The same would be the case in relation to trying obtain retrospective waive of the Republic's statutory right to purchase TNG in relation to transfers which took place after the 2004 Amendments (see paragraphs 13.22 to 13.23 above).

- (b) The Claimants argue that at the time of its alleged transfer of TNG, Gheso and Terra Raf were affiliates (see paragraph 141 and 142 of the SoC) and therefore, notwithstanding the previous illegalities relating to the transfer of TNG, they did not require consent to the transfer from the Government of the Republic or the MEMR. However, the Claimants have not provided any evidence of what was required for companies to be regarded as affiliates or that Gheso and Terra Raf were affiliates. The Arbitral Tribunal should therefore conclude that these companies were not affiliates and therefore that the Republic did have a right to acquire TNG.
- (c) From paragraph 143 and 144 of the SoC and the correspondence exchanged between TNG and the Republic in 2006 and 2007 in relation to the Claimants attempts to rectify its illegal transfer of TNG after it became impossible to do so; once TNG was reorganised into an LLP, the following is clear:
- (i) The Claimants did not seek consent to the transfer from the Republic at the time of the transfer and in fact had not even notified the Republic that all of Ascom's share had been transferred to Gheso (**Exhibit C-131**);
 - (ii) The Republic notified the Claimants that it failed to obtain such consent and that it failed to give the Republic priority to purchase TNG at the time of the transfer in its letter dated 13 February 2007 (**Exhibit C-132**). The Republic requested that TNG provide it with various information relating to the transfer and the Claimants have disclosed no documents which suggest that they ever provided this information. In fact, the Claimants have disclosed no documentation showing that they even replied to the Republic's letter;
 - (iii) TNG have disclosed two internal government documents as evidence that the Republic granted consent to the transfer (**Exhibits C-133 and C-134**). TNG have given no evidence that these documents were ever legitimately shared with it, nor has it provided any evidence that the Republic subsequently wrote to TNG granting it consent to the transfer; and
 - (iv) The Claimants have therefore not established that they actually requested consent to the Gheso to Terra Raf transfer from the Republic. They have also not established that they received any approval from the Republic to the transfer. These are documents that should be in their control given that TNG sent and received these letters. The Republic therefore denies the assertions the Claimants have made. Furthermore, for the reasons set out above the transfer was clearly illegal.
- (d) In response to the Claimants' assertion that the Republic decided to retroactively reverse its decision to consent to the transfer in February 2007 after President's Nazarbayev allegedly ordered various ministries to conduct audits (see paragraph 145 of the SoC):

- (i) For the reasons set out above the transfer was illegal and the Republic had clear legal grounds to investigate the transfer and conclude it was illegal;
 - (ii) As we have set out in paragraph 18 below, President Nazarbayev did not give any such order and the Claimants have provided an incorrect translation of President Voronin and President Nazarbayev's communications; and
 - (iii) There is no connection between the legitimate audits the Republic carried out (as set out in paragraphs 19 and 20 below) and the validity of TNG's transfer from Gheso to Terra Raf.
- (e) All that the Claimants' asserts in paragraphs 145 to 155 of the SoC simply shows that the Republic was attempting to understand the legality of the transfer and ownership of TNG as follows:
- (i) A number of the Claimants exhibits (see **Exhibit C-140, C-144 and C-146**) show is that the Republic had not received the correct documents in relation to the registration and transfer of TNG.
 - (ii) In particular, it is clear that the Republic had concerns that the Claimants had forged documents relating to the transfer. The Claimants have not addressed allegations particularly those in the press article dated 18 December 2008 (**Exhibit C-141**), which corroborates the Republic's view that there were serious irregularities in the registration documents relating to the transfer from Gheso to Terra Raf and that it provided documents "*which had as a result the influence upon the economic activity of the company in terms of taxation and obtaining profits*".
 - (iii) Under these circumstances and the Republic's suspicions as to the legality of the ownership and conduct of TNG, the Republic was right to consider whether its pre-emptive right to purchase TNG was applicable as it had reason to believe that a transfer took place after the 2004 Amendments. In the circumstances at the time it was reasonable for the Republic to ask the Claimants to apply for its rights to be retrospectively waived. However, as set out in paragraph 19 above, it has become apparent to the Republic that the Claimants could not rectify any of the illegalities concerning its ownership after the reorganisation of JSC TNG to LLP TNG.
 - (iv) Once it had uncovered this, there was no legal reason to give consent to the transfer. This would not rectify the problems with the ownership of TNG.
 - (v) In relation to the meeting held between TNG and the MEMR on 19 March 2009, the Claimants have produced minutes which allege that Mr. Batalov assured the Claimants that all outstanding issues in relation to TNG and KPM would be resolved in its favour. It is simply not the case that the minutes say this (**Exhibit C-42**).

- (vi) In addition the minutes were not signed by the MEMR and therefore the Republic disagree with any implication by the Claimants that this was an accurate record of what happened at the meeting.
- (f) The Claimants have placed considerable emphasis on the approval given by the Republic for the transfer of KPM and TNG to Tristan Oil as part of an IPO on the London Stock Exchange (paragraph 144 of the SoC). Notwithstanding that this is irrelevant to the transfer of TNG from Gheso to Terra Raf, the following points are interesting to note:
 - (i) The Claimants have not actually disclosed any letter requesting the Republic's approval to the transfer of TNG to Tristan Oil. Instead they have only provided the letter they sent in respect of the transfer of KPM, which is irrelevant to the matter (**Exhibit C-135**);
 - (ii) As a result the Claimants have not give any proof that they actually requested such consent nor have they given any evidence that they disclosed documents relating to the transfer;
 - (iii) Whilst the Republic did approve of the transfer of TNG's shares to Tristan Oil (**Exhibit C-139**) the Republic later revoked this decision. The reason for this was that it later became clear, for the reasons set out above, that Terra Raf had unlawfully purchased shares in TNG as set out above, and for the reasons set out below, TNG did not actually have a licence to carry out mining operations in Kazakhstan; and
 - (iv) It was therefore concerned that allowing Tristan Oil to float on the LSE would mean that potential public shareholders would be purchasing shares in Tristan Oil on the basis that it owned the assets of TNG, when in actual fact this was not the case.

(c) Illegality as a result of KPM and TNG failing to have licences for subsoil use

The license and contract system

13.48 Under the following provisions of Kazakh law, subsoil users need both a licence (which is the primary document) and a contract (the secondary document), which must comply with the conditions set out in the licence:

- (a) Article 16 of the Law "On Oil" as of 1995, which was in effect until August 1999 provides:

"1. No one shall have the right to carry out Exploration and Production without a respective License";

2.The Contract shall comply with the conditions of the License. The provisions of the Contract contrary to the License conditions are invalid"

(Exhibit R-23)

13.49 In 1999, the Republic abolished the licensing system and replaced it with a standalone contract system. However, the legislation provided that this abolition did not apply in relation to licences/contracts signed prior to that date as set out in paragraph 3 of article 2 of The Law dated 11 August 1999 No. 467-1 "On amendments and addenda to some legislative acts of the Republic of Kazakhstan concerning subsurface management and oil operations in the Republic of Kazakhstan":

*" all mineral licenses issued prior to entry into effect of this Law shall **remain in force until the expiry of their term**, including the extension periods, in accordance with the **legislation of the Republic of Kazakhstan in force as of the time** of issuance of such licenses"* [emphasis added] **(Exhibit R-23)**

13.50 The Law dated 1 December 2004 No. 2-III "On amendments and addenda to some legislative acts of the Republic of Kazakhstan concerning subsurface management and oil operations in the Republic of Kazakhstan" confirmed this approach:

"based on article 2 mineral licenses issued prior to entry into effect of the Law shall remain in force until the expiry of their term, including the extension periods, in accordance with the legislation of the Republic of Kazakhstan in force as of the time of issuance of such licenses " **(Exhibit R-22)**.

13.51 The obligation to renew and register a licence lies with the subsoil user. Subsoil users were required to apply to the licensing body and providing all of the required documents **(Exhibit R-24)**.

13.52 It is also relevant to consider the activity which KPM and TNG were entitled to carry out under their respective Subsoil Contracts and Subsoil Licences. Those activities were as follows:

(a) For KPM

(i) Under Subsoil Contract 305:

"Section 1 Definitions

1.13 Contract Area stands for the territory defined in Appendix 3 of the Licence by geographical coordinates and allocated for carrying out Exploration and Production Operations.

"Section 7 General Rights and Obligations of the Parties

7.1 Contractor has the right to:

7.1.1 Carry out Exploration and Production in the Contract Area on an exclusive basis.” (Exhibit C-45)

- (ii) Under Appendix 3 of Subsoil Licence MG No309-D the Contract Area is defined as a particular area within the Borankol field. (Exhibit C-45)
- (b) For TNG
- (i) Under Subsoil Contract 210

“Section 1 Definitions

...

1.4 Geological allotment - means the document, enclosed to the Licence of Series MG No. 243 (crude oil), determining spatial borders of the given area of subsoil within the limits of which the execution of exploration works within the Contract Area is authorised

...

1.16 Contract Area means the territory determined in the Geological allotment

...

Section 6 General Rights and Obligations of the Parties

6.1 The Contractor has the right to:

6.1.1 Carry out Exploration and Production on the Contract Area on an exclusive basis according to conditions stipulated in the Licence” (Exhibit C-52)

- (ii) Under Appendix 3 of Subsoil Licence MG No. 243 the Geological allotment is defined as a particular area within the Tolwyn Field¹¹⁴

Law on transformation/reorganisation of entities and licensing

13.53 The Law "On licensing" 1995 (with amendments and addenda as of 12 January 2007) Article 15 states:

“in case of a change in the name (including the change of the form of incorporation), place of business (if it is designated in the license) of a legal entity it should file within

¹¹⁴ As regards the definitions of “main pipeline” and “contractors pipeline” referred to later in this Statement of Defence, to the extent that any pipeline is outside the boundary of a subsoil contractor’s Contract Area, it is not a contractor’s pipeline.

one month an application for re-issuance of the license enclosing all respective documents confirming the presented data.” [emphasis added] (Exhibit R-24)

13.54 Similar provisions are contained in legislation which was in effect at the time KPM and TNG were allegedly reorganised as LLP’s from joint stock companies:

- (a) According to article 22 of The Decree of The President of The Republic of Kazakhstan dated 28 June 1995. N2350 On Oil (**The Decree on Oil**) (**Exhibit R-25**), the validity of The License expires:
 - (i) upon expiry of The License term;
 - (ii) upon revocation of The License by The Licensing authority in accordance with article 23 of The Decree on Oil;
 - (iii) in the event of termination or changes made to the conditions of the Contract, concluded under the License;
 - (iv) in the case of liquidation or **reorganisation** of the legal entity, in the name of which The License was issued.

The contracts and licenses of KPM and TNG

13.55 The Claimants’ case centres around three contracts which were underpinned by and signed on the basis of previously obtained licences:

- (a) **Contract No. 210** which was signed by TNG (for exploration and mining) on the basis of **License MG No.242-D** (in effect as of 4 December 1997). The contract was signed on 12 August 1998, 7 months after the licence was issued (**Exhibit C-52**).
- (b) **Contract No.305** which was signed by KPM (for exploration and mining) on the basis of **License MG No.309-D** (in effect as of 27 March 1996). The contract was signed on 30 March 1999, approximately three years after the license was issued (**Exhibit C-45**).
- (c) **Contract No. 302** which was signed by TNG (for the exploration of hydrocarbons only) on the basis of **License MG No.243-D** (in effect as of 4 December 1997). The contract was signed on 31 July 1998, approximately 8 months after the license was issued (**Exhibit C-53**).

13.56 With each of the above contracts and licences, it was necessary to first amend the license and only then could the contract be amended in accordance with both Kazakh law and the terms of each contract (see paragraphs 6.2.3 and 27.5 of The Contract No. 302, paragraphs 7.1.2 and 32.5 of The Contract No. 305, paragraphs 6.1.2 and 27.5 of The Contract No. 210).

13.57 The Claimants were clearly aware of the need to make the appropriate amendments to the license in the event that changes are made to the Contracts as they have complied with these requirements on occasions in the past:

- (a) The Claimants have disclosed a letter dated 23 December 1999 at (**Exhibit C-49**) requesting such amendments in relation to licence MG No. 309-D which corresponds with Contract 305; and
- (b) Prior to the Sale and Purchase Agreement for TNG dated 28 May 2002, a Resolution of the Government of the Republic of Kazakhstan of 19 July 2001 No. 978 "*On the change of ownership and changes in the license for the right to subsurface resources management ... in relation to the license MG No. 242-D dated 4 December 1997*" (**Exhibit C-52**) was passed which corresponded to amendments to Contract 210.

Amendments to the contracts and failure to amend the corresponding licenses accordingly

13.58 Since the Claimants illegally became owners of KPM and TNG and signed the contracts a considerable number of amendments have been made. Many of these amendments required alterations of the license conditions. In these circumstances, changes should have firstly been made to the licence. Only after this could the corresponding contract be amended.

13.59 The Claimants ignored this legal requirement to amend the licences and on numerous occasions failed to apply for any amendments to the licenses when it was required. This is particularly evident when considering the extensions the Claimants applied for under each contract:

- (a) In relation to extensions under contract 210, the initial period for exploration and extraction was 3 years. Paragraph 3.1.1 of the contract enables the parties to extend this time period in accordance with Kazakh law and the deadline was subsequently extended three times under the contract. On the first occasion, when the period was extended from 3 to 5 years, the Claimants did apply to amend the license (pursuant to an agreement dated 28 May 2002). However, in breach of Kazakh law, the Claimants failed to make the corresponding amendments to the license on the other two occasions:
 - (i) When the Claimants applied to extend the contract from 5 to 7 years pursuant to an addendum dated 19 November 2003; (**Exhibit C-52**)
 - (ii) When the Claimants applied to extend the contract from 7 to 9 years pursuant to an addendum dated 1 February 2005. (**Exhibit C-52**)
- (b) In relation Contract 305, the period for exploration and extraction was initially 4 years (paragraph 9.1) and when this was twice extended, in breach of Kazakh law, the Claimants failed to make any amendments to the licence:

- (i) When the contract was extended from 4 to 6 years pursuant to an Addendum to the Contract dated 19 May 2003. (**Exhibit C-45**);
 - (ii) When the contract was extended from 6 to 8 years, until 29 March 2007 pursuant to Addendum No. 4 to the Contract dated 1 February 2005 (**Exhibit C-45**).
- (c) In relation to contract No. 302, the initial period for exploration was 6 years (paragraph 3.3) and whilst the contract was extended twice, no amendments were made to the licence:
- (i) When the contract was extended from 6 to 8 years pursuant to the Addendum to The Contract dated 19 December 2003; (**Exhibit C-53**)
 - (ii) When the contract was extended from 8 years to 10 years and 8 months, until 30 March 2009 (due to a force-majeure event as a result of the surge flood of The Caspian Sea) pursuant to Addendum No.4 dated 7 February 2007. (**Exhibit C-53**)

13.60 Based on the above, the Claimants did not extend the licences and the consequence of this was that the contractual extensions were invalid as they failed to correspond with the license provisions.

13.61 In addition, when the Claimants attempted to reorganise/transform KPM and TNG as LLP's from joint stock companies, whilst it amended the contracts in accordance with:

- (i) Addendum No. 7 to Contract No. 210 dated July 28, 2006 (**Exhibit C-52**);
- (ii) Addendum No. 4 to Contract No. 302, dated December 1, 2006 (**Exhibit C-53**); and
- (iii) Addendum No. 5 to Contract No. 305, dated March 30, 2006 (**Exhibit C-45**),

the Claimants did not apply for licenses to be renewed in accordance with Kazakh law.

13.62 For this reason the reorganised KPM and TNG did not have licenses registered in their new name so the new entities would have effectively have been carrying out illegal mining, without the proper license, in breach of Kazakh law.

13.63 This activity is considered by the Republic as illegal activity and entails respective responsibility under the legislation of the Republic of Kazakhstan(**Exhibit R-58**). Furthermore, this kind of activity is a reason for the liquidation of the legal entity by the court's order, pursuant to paragraph 2 of Article 49 of the Civil Code of the Republic of Kazakhstan (**Exhibit R-8**).

14 Low post-acquisition investment in KPM and TNG, the development of the fields, the LPG Plant and the 302 Properties

Amounts paid for KPM and TNG

- 14.1 The Claimants made no payments in relation to its initial purchase of 62% of the shares of KPM. It managed to receive this shareholding completely free of charge. According to the Articles of Association for KPM, the Claimant was required to pay LLP Aksai 1,500,000 USD, as well as make investments in accordance with the work program. However, it failed to fulfil both of these obligations and make any such investment (**Exhibit R-38**).
- 14.2 As set out above, the Claimants have provided no information on the price it paid for the purchase of the remaining 32% of shares in KPM and therefore there is no evidence that the Claimants paid anything to acquire KPM.
- 14.3 100% of the shares of TNG were purchased for about 190 thousand dollars (**Exhibit R-39**) and not US\$617,333 as set out in the share purchase agreements exhibited by the Claimants.
- 14.4 As set out above, this ownership was unlawful and amounted to an illegal investment. In addition, the Claimants engaged in activities that required a license but failed to renew the license at the appropriate times.
- 14.5 In these circumstances, the Claimants could not carry out normal economic activities as an investor. It was clear that the Claimants only acquired the companies to subsequently resell the business rather than participate meaningfully in the oil and gas business in Kazakhstan. This can be seen further from the analysis of Project Zenith above, in which it is apparent that the attempt to resell was the whole purpose of this project. Before considering this further the Arbitral Tribunal should note the lack of investment the Claimants made post acquisition.

Post acquisition investment in KPM and TNG

- 14.6 As regards post acquisition investment in KPM and TNG the Claimants allege that they have invested over \$1 bn in the companies (see paragraphs 5 and 6 of the SoC). However they have presented no evidence that:
- (a) KPM or TNG received any such investment; or
 - (b) that any post acquisition investment was made by any of the Claimants.
- 14.7 The Claimants have also asserted that they have made payments in the region of USD500m in taxes (see paragraph 6 of the SoC) but have failed to show that these payments were ever made. In fact, the Claimants were regular tax offenders as set out in Paragraph 30 below.

Tristan Oil

- 14.8 In fact from looking at the 2009 financial accounts for Tristan Oil, the bulk of KPM's financing is from Tristan Oil who it owed US\$50m to at the end of 2008 and US\$14,572,985 at the end of 2009 (**Exhibit 68 of the FTI Report**, page F-113). This suggests that the real substantial investor in the company was Tristan Oil and not Ascom.
- 14.9 From looking at the 2009 accounts for Tristan Oil, the majority of its financing was from Tristan Oil who TNG owed US\$275m to at the end of 2008 and US\$208,758,685 to at the end of 2009 (**Exhibit 68 of the FTI Report**, page F-158). Indeed it is difficult to see what investment if any has been made in TNG by Terra Raf. The financial statement of TNG for 2009 does not show any subsequent investment by Terra Raf in TNG (**Exhibit 68 of the FTI Report**, page F-173). In fact it appears that Terra Raf is nothing more than a shell company existing only to hold shares in TNG without participating itself in the investment.
- 14.10 Accordingly, the majority investor in both TNG and KPM appears to be Tristan Oil. The rest of the Claimants are, at best, minority participants in the investment.
- 14.11 According to paragraph 3.3 of the FTI report exhibited by the Claimants, Tristan Oil is a company registered in the British Virgin Islands and accordingly is not entitled to protection under the ECT. It appears therefore that the Claimants are seeking to avoid the issue that they are at best minority investors in KPM and TNG, whilst the true investor is Tristan Oil, which is not entitled to be a party to these proceedings and, notably, has not made any complaint let alone sought to initiate any sort of claim in relation to the events which the Claimants describe.
- 14.12 It is also noted that Tristan Oil has not intimated any claim against the Republic, as it might reasonably have been expected to do if, as alleged, Tristan Oil provided investment funds to KPM and TNG and, as alleged, the Republic had expropriated that investment.

Alleged Assets

Investment in Borankol and Tolkyn Fields

- 14.13 The Claimants have not adequately proved their investments in the Borankol and Tolkyn fields in section 111A of the SoC. In reality their investment was small. Moreover, the development of those fields was far less significant than claimed.

LPG Plant

- 14.14 As to the Claimants' alleged investments in the LPG Plant, the Republic has the following observations:
- (a) The Claimants have provided no evidence that the LPG Plant was 90% complete at the point when TNG (out of its own choice) stopped developing the plant in March 2009 (paragraph 64 of the SoC). In addition there is no evidence that it would not cost more to

complete than the Claimants' unsubstantiated estimate of \$24.1 (paragraph 16.6 of FTI Report);

- (b) TNG cannot attribute to the Republic its decision to neglect the plant at this early stage and later abandon it completely, who, for the reasons set out below did not engage in any sort of discriminatory harassment campaign against TNG. In any event, the alleged expropriation of the Claimant's investments did not occur until over a year later;
- (c) It should be noted that whilst the Claimants assert that it invested USD245million in the development and construction of the LPG Plant, the article exhibited at C-187 suggests only USD176.5m had been invested;
- (d) In terms of the potential market;

14.15 The Claimants have exhibited a Joint Operating Agreement between Vitol, Ascom, TNG and Terra Raf dated 27 June 2006 (**Exhibit 44 to the FTI Report**), which shows that whilst TNG was to 'own' the operating plant the actual investment into the plant was split between:

- (a) a US\$20m loan from Vitol;
- (b) a US\$20m equity investment by Ascom; and
- (c) the rest of the financing was to be provided pursuant to a loan agreement with Kazkommertzbank and via prepayments from Vitol to Terra Raf pursuant to a crude oil and marketing services agreement (clause 2.3).

14.16 Based on this, the only financial investment by the Claimants would appear to be US\$20m contributed by Ascom with all other investment relying on prepayments from Vitol or loans. The Claimants have therefore made very little investment into this project.

Contract 302

14.17 The value of the Contract 302 Properties has never been proven and in any event, for the reasons set out below, TNG's ownership of the contract expired in March 2009.

14.18 In terms of its alleged USD43m investment (paragraph 66 of the SoC), the Claimant is put to proof as to how exactly it utilised its capital expenditure since the sum total of TNG's activities appear to be the drilling of two exploratory wells. Furthermore, the Claimants are put to proof as to whether any of the sums expended by TNG were in fact funded by the Claimants.

14.19 It is also apparent that, even on the estimation of their own experts, a further 129 well bores would be required to exploit this area (FTI Report, pages 5-6) at a cost of between \$619,751,664 and \$699,115,666 based on the Claimants' assessment of the drilling cost per well at 2008 prices (FTI Report, page 93). It is worth noting that the Republic's experts consider that the Claimants'

assessment of the average cost per well for the Tolwyn field is considerably lower than the actual cost because the Tolwyn field requires much deeper and technically more complex wells (especially for the InterOil reef) than the Claimants have assumed (GCA, pages 16 and 17). In any event it is clear that, even on the Claimants' evidence, a monumental level of expenditure would be required just to drill the wells required to exploit the Tolwyn field (leaving aside any other capital or operational expenditure). Accordingly, even the Claimants' alleged expenditure is miniscule in terms of that required to extract the value which the Claimants say exists in the Tolwyn field.

14.20 Before expanding on the expiry of the Contract 302 Properties, the history of the properties is of some significance (**Exhibit C-53**).

(a) The Area:

- (i) Contract 302 on exploration of hydrocarbons was signed on 12 August 1998 in respect of blocks XXX-15-A (partially), B (partially),-D,-E (partially),-F (partially), XXX1-15-A,-B,-C (partially).
- (ii) This was reduced to 743 square kilometres, due to the return in March 2006 of the Northern and Southern parts of the deposit and Kultuk field.
- (iii) The area covered was further amended in 2008 by the addendum to the contract №6 in connection with the return of the territory for the transfer and adherence to the contract № 210 TNG, because of the submission of the commercial detection of the Tolwyn field and the statement of its reserves (Minutes SCR RK № 559-07-U dated 01/17/07), and the issue of new mining lease contract 210 in the contours of approved reserves of the Tolwyn field.

(b) Extensions:

- (i) Licences under Kazakh law are valid for 6 years and comprise of two phases of exploration: the first last 2 years and the second lasts 4 years. Licence No 243 was issued on 4 December 1997.
- (ii) Extensions to the exploration period were granted twice for the Contract 302 Properties. The first time the extension ran for 2 years from 31 July 2004 to 31 July 2006. The second time, the extension related to a period of 2 years and 8 months from 31 July 2006 until 30 March 3009 (in respect of an event of force majeure recognised by the Republic).
- (iii) TNG made applications citing commercial discoveries which were subsequently revoked. The Claimants state that these were "*premature*".

14.21 The fact that the Claimants withdrew its statement of intention to begin evaluation suggests that its exploration had been far from successful (see paragraph 67 of the SoC and Exhibits C-130). Certainly, the Claimants' experts consider that the prospect of actually recovering the reserves assessed is very low:

- (a) For the comparatively small volume of contingent reserves - between 50 and 90% probability. These resources amount to 57.9mb of oil and condensate and 42.8 BCF of natural gas (Ryder Scott Report pages 5 and 6);
- (b) For the comparatively voluminous prospective reserves - between 5 and 30%. These resources amount to 58.7mb oil and condensate and a huge 1128 BCF of natural gas (Ryder Scott Report, pages 5 and 6).

14.22 Further, the Republic's expert is not even prepared to classify the InterOil reef as a 'prospective resource' (the least well proved category of reserve or resource) noting:

"In conclusion, there is insufficient data (and hence, evidence) for the presence of a prospect. The InterOil Reef Lead would therefore be more appropriately described as a "concept" or "play" as there is little or no data to support its presence (Appendix III)." (Paragraph 99 of GCA Report)

14.23 The InterOil reef accounts for 53mb of condensate and 1049 BCF natural gas of the Claimants' so called prospective reserves, i.e. almost all of it (page 6 of Ryder Scott Report). It is therefore little wonder that the Claimants withdrew its statement of intention to begin evaluation considering the huge costs of exploitation and the almost certain prospect of complete failure to locate any commercially exploitable reserves.

14.24 Notwithstanding this and the lack of investment, the contract had validly expired.

14.25 The Claimants have tried to assert that they had a contractual right to extend the period for exploration of the Contract 302 properties. The Arbitral Tribunal should not be misled by this assertion which is clearly incorrect from the terms of the contract and the licence:

- (a) Clause 3.3 of Contract 302 provides (**Exhibit 53**):

*"Exploration Period may be extended by no more than two period of up to two years upon **mutual agreement of the Parties**, in accordance with the current Legislation, provided, however, that the Contractor shall submit to the Competent Body a New Minimum Work Program.*

- (b) Clause 6 to the License for the Contract 302 Properties provides:

"6. Conditions for extension of the License: the License may be extended only by the Resolution of the Licensor [the Republic]."

- (c) Based on the above, if TNG wanted to extend the period for exploration it required the consent of the Republic to both extend the Exploration Period and the License. TNG had no contractual right to any such extension and whether or not it was granted clearly required mutual agreement from each party.
- 14.26 The Republic in good faith agreed to an initial two year extension before the Contracts were initially due to expire and further raised no objections to the force majeure reasons for allowing the contract to be further extension (**Exhibit C-53**). In any event, for the reasons set out in Paragraph 3 above, this extension was invalid.
- 14.27 However, the Republic had no obligation to extend this again and considering the lack of progress the Claimants had made (**Exhibit C-66**), objectively it had no reason to allow the Claimants to continue exploring this area. The Claimants were well aware that could lose any sums it had invested on if it failed to progress following its exploration and after being given a considerable amount of time to explore, the Republic could not simply allow the land to perpetually remain in its possession.
- 14.28 Furthermore, the Arbitral Tribunal should be aware that from an objective point of view, no investor could possibly assume that the Republic would automatically grant such an extension. Statistics¹¹⁵ (**Exhibit R-165**) show that:
- (a) In 2008, the Republic received 152 applications by licensee/contractors for an extension to the exploration and 31 of those applications were denied;
 - (b) In 2009, the Republic received 139 applications by licensee/contractors for an extension to the exploration and 38 of those applications being denied.
- 14.29 The Claimants were therefore in no circumstances discriminated against and in fact received relatively liberal treatment given the lack of progress it had made in its exploration activities.
- 14.30 Even on the Claimants own case, the logic of their allegation is seriously flawed since the Claimants themselves state that the “refusal” to extend this contract in 2009 formed “a critical element of the State’s harassment campaign” amounting to (they allege) the indirect expropriation (paragraph 175 of the SoC). If the Claimants are correct, and the Contract 302 Properties were not extended in “bad faith”, then surely the expropriation of this asset occurred in 2009, not 2010, as the Claimants alleged.
- 14.31 It is not evident that this is pleaded on an “alternative” basis, leaving it unclear as to the Claimants’ preferred position on this point. Worse still, the Claimants’ characterisation of these

¹¹⁵ **Exhibit R-165**

events masks the reality that, on a contractual footing, the Contract expired in March 2009 (**Exhibit C-53**).

14.32 In relation to the evidence the Claimants have tried to rely on to state that the Republic acted in “bad faith”, the Republic has the following criticisms:

- (a) There is nothing in the minutes which the Claimants have referred to (paragraph 177 of the SoC and (**Exhibit C-47**)) which suggest that the Republic would resolve this issue in its favour. All the minutes suggest is that it needed to review the technical issues surrounding the supposed discovery of oil and gas on Munaibai before making its decision. As the Republic’s experts remark, “*tests do not conclusively demonstrate the potential commerciality of the East Munaibai discovery. Additional appraisal drilling and testing will be required to demonstrate the commerciality of the discovery.*” Therefore, on this basis alone, the Republic was right to be sceptical.
- (b) In any event, the minutes are not agreed to by the Republic and were not signed by anyone from the MEMR at the meeting.
- (c) The letter the Claimants have enclosed at **Exhibit C-27** stating that the extension had been agreed was clearly subject to contract, and expressly stated to be so, by its reference to contradictions, modifications needing to be made. Furthermore, the letter was not a formal decision as any extension required sign off from both the competent authority (MEMR) and licensing authority (the Government of the Republic) to amend both the licence and the contract. TNG could not simply unilaterally impose an Addendum on the Republic and expect it to sign this without question.
- (d) Furthermore, the Claimants fundamentally took the incorrect approach to seek an extension by only applying to extend the term of the contract when they should have applied to also extend the term of the license:
 - (i) This was essential given that the license is the primary document which is needed for exploration and extraction of energy resources in Kazakhstan as set out in paragraphs 13.48 to 13.63 above, and the contract could only be extended once the licence had been.
 - (ii) TNG were only entitled to seek an extension pursuant to paragraph 6 of Licence MG No 243-D, if it obtains the consent of the licensor (i.e. the Government).
 - (iii) The Claimants were also entitled to seek an extension pursuant to paragraph 27 of the “*Provision On the Procedure of Subsoil Use Licensing in the Republic of Kazakhstan approved by Resolution of the Government of the Republic of Kazakhstan No. 1017*” of 16 August 1996 (**Exhibit R-164**) which was in force at the

time, and provides that a licensee can apply for such an extension from the licensing authority not later than 12 months before expiry of the license.

- (iv) Under Article 29(1) of Decree of the President of the Republic of Kazakhstan No. 2350 On Oil of 28 June 1995 (**Exhibit R-211**), which was in force at the time, the terms and conditions of a contract can only be extended if they comply with the terms of the license. Any extension to the contract would therefore require an extension to the license to ensure the terms were consistent.
- (v) As TNG failed to apply to extend the term of the license, it could never legally have been granted an extension to the term for exploration under Contract 302.
- (e) In reality, the Republic acted in good faith to extend the contract as permitted by law. The Claimants allege in the Statement of Claim that the Republic's failure to extend the contract meant that "the Claimants were "unable to establish the full monetary value of the reserves in the Contract 302 Properties" (see paragraph 179). The fact that the Claimants failed to maximise the opportunity to explore the asset within the contractual term (notwithstanding ample opportunity) and, therefore, failed to realise profits is not an adequate reason to seek compensation from the Republic under the ECT.

14.33 If the Claimants had strong objections to the fact that the Republic did not grant it an extension it could have referred the issue to the Kazakh courts:

- (a) Under Article 9 of the Civil Code of the Republic (**Exhibit R-8**), the Claimants were entitled to refer to judicial authorities for the protection of any its rights that were infringed, as a result of the Republic's legitimate decision to not extend the exploration period under Contract 302.
- (b) In addition, TNG had the right, under Article 402(2) of the Civil Code of the Republic (**Exhibit R-8**), to file a claim with the Kazakh courts for the modification of the contract if the competent authority did not accept its proposed modifications.
- (c) The Arbitral Tribunal should note that the Kazakh courts have reinstated contracts that had terminated/expired in the past (**Exhibit R-153**).
- (d) However, TNG and the Claimants failed to utilise this local court appeal mechanism and instead decided to belatedly bring the issue up in these international arbitration proceedings.

14.34 Upon expiry, Contract 302 legally terminated under paragraph 1 of Article 73 of the Subsoil Law 2010:

“1. A contract shall be terminated upon expiry of its validity term unless the parties agree to extend the validity term as provided for by Article 69 of this Law.” (Exhibit R-152)

14.35 This contract and the area licensed by it cannot, therefore, be regarded as being an investment for the purpose of this arbitration because it ceased to be any kind of asset of the Claimants in March 2009.

15 Decline in the Claimants’ Investments

15.1 It is also apparent that, in various respects the Claimants’ investments were in a state of decline and/or that certain significant qualities which the Claimants say their investments possessed were in fact lacking. This had nothing to do with the Republic’s actions.

Borankol field

15.2 In relation to the amount of crude oil, condensate and gas production from the Borankol and Tolkyn fields, on the Claimants’ evidence alone (as set out in section 6 of the FTI Report), the following is clear:

- (a) In relation to the Borankol field, liquid production was declining from 2005 onwards and gas production was on the decline from 2004 onwards (see FTI Report 6.5 to 6.7); and
- (b) In relation to the Tolkyn Field, production was on the decline from 2005 and until 2007 until there was a jump in production from 2007 to 2008. However this sudden increase in gas production led to an associated increase in water production (GCA, page 6) which in turn led to a significant and sustained reduction in gas production, a situation that continues to date (GCA, page 7).

15.3 Market for Natural Gas

15.4 The Claimants make references to various restrictions in potential sales and the value of exporting gas including:

- (a) Its agreement to deliver gas to Moldova at a substantial discount, which fell through (paragraph 57 of the SoC).
- (b) the valid restriction placed on TNG from the Kazakh Competition Authority which prevented it from raising gas prices without its prior approval (**Exhibit C-66**). The Claimants assert that this meant it sold its gas at prices below those on international market. Notwithstanding these points, TNG was in a position to approval to increase these prices but has not produced any evidence to suggest that it even tried to obtain such approval (paragraph 57 of the SoC).

- 15.5 The Claimants allege that as part of the alleged expropriation the Republic prevented a tri-partite between TNG, KazAzot and KazMunaiGas from being signed which would have allowed it sell certain volumes of gas at a price substantially above its discounted prices and it could export certain volumes of gas at international market prices (paragraph 61 of the SoC).
- 15.6 As a preliminary point to note, the Arbitral Tribunal should be aware that the whole purpose of the parties even considering the tri-partite agreement was to allow the Republic to develop an Ammonia-Carbamide project and not to allow the Claimants to export gas at increased prices (paragraph 58 of the SoC). The aim of this project was to allow the country to produce its own fertilizers. The project cannot be considered as part of the Claimants' investment in Kazakhstan as it was part of an individual project which was instigated and was to be implemented by the Republic (and not the Claimants').
- 15.7 In relation to the Claimants' allegation that the Republic prevented the tri-partite agreement from being signed, it is simply not the case that the Republic ever did this:
- (a) The Claimants have failed to prove that the Republic instructed KazAzot not to sign the final version Tripartite Agreement (paragraph 61 of the SoC). Their reliance on a letter from the Governor of the Mangystau Region (**Exhibit C-155**) is misguided as:
 - (i) It makes no reference to the tripartite agreement;
 - (ii) it is not addressed to KazAzot, does not refer to KazAzot, and in no way directs that KazAzot do not sign the tripartite agreement;
 - (iii) it does not imply the transfer of TNG's assets to KazAzot as the Claimants assert nor does it in any way state that the Prime Minister instructed the MEMR, the Ministry of Finance, the Ministry of Justice and Samruk-Kazyna to orchestrate the termination of the Subsoil Use Contracts; and
 - (iv) the letter only points to the clear contractual breaches by KPM and TNG as a result of the financial violations committed and deterioration of its industrial and financial situation, which would have entitled the Republic to legitimately terminate the contracts. This advice is completely irrelevant to the Ammonia-Carbamide Project and there is nothing to suggest that this advice was in any way followed at the time of the letter (26 August 2009).¹¹⁶
 - (b) In any case the fact that this agreement was not signed is evidence enough that parties did not agree to TNG having the right to export gas at the prices agreed in the draft tri-partite agreement. In fact, the Claimants have given no evidence that the parties had

¹¹⁶ This letter is considered further in section 18 below

even discussed that TNG would be allowed to export gas at higher prices as stated in paragraphs 58 and 60 of the SoC:

- (i) The Memorandum of Understanding (which was in any event agreed at a very early stage 7 May 2007) makes no reference to any terms which evidence that the parties had actually agreed that TNG could export gas at an increased price (**Exhibit C-300**);
- (ii) an agreement for the implementation of the Memorandum of Understanding of 7 May 2007, dated 28 April 2008 (**Exhibit C-301**) also makes no reference to the parties agreeing the actual terms for TNG exporting gas at an increased price and only makes vague reference to a formula;
- (iii) the minutes of a meeting on 16 May 2008 (**Exhibit C-63**) make no reference to TNG having the right to export gas at an increased price and only states that the parties 'should' sign the tripartite agreement (and not that the parties actually signed the agreement as states in para 5.26 of the FTI Report); and
- (iv) the preliminary version of the Tripartite Agreement (**Exhibit C-302**) which involved KazTransGas clearly was not effective given that:
 - (A) it was undated;
 - (B) the Claimants have provided no evidence that the conditions in clause 2.2 to the agreement had been fulfilled which would have enabled the agreement to enter into force, including that KazTransGas was given permission to enter into the deal by KazMunaiGas and that KazTransGas was designated as exclusive operator for the export of gas;
 - (C) the Claimants have provided no evidence that the terms for exporting gas were ever employed in practice and it is clear that it was never intended that the terms could be relied upon, given that a subsequent version was considered with KazMunaiGas replacing KazTransGas.
- (v) the final version of the Tri-Partite Agreement signed only by TNG and KazMunaiGas (**Exhibit C-77**) is not evidence of an agreement considering that the actual user of the gas, KazAzot had not signed up to it. This is particularly the case given that (as referred to in paragraph 5.33 the FTI Report) Tristan Oil's actual accounts state that the conditions precedents to the agreement were never satisfied and therefore the contract was void.

(vi) The Claimants have provided no other evidence relating to the lead up to the draft tri-partite agreement indicating any intention on KazAzot or the Republic's part to allow TNG to export gas at increased prices.

(c) The actual reason why KazAzot did not sign the agreement can be seen from its letter #65-01-06/871 dated 28 April 2009, which was sent to KazMunaiGas NC JSC (**Exhibit R-213**). From this letter it can be seen that the preliminary results of the audit it carried out found that the construction of the Ammonia-Carbamide complex was not feasible taking into account negative impact the global financial crisis had on the mineral fertilizers market (the prices for various fertilizers had more than halved in the fourth quarter 2008 and there was a constant trend of price-reduction for these products in the first four months of 2009). In addition, KazAzot stated in the letter that natural gas prices and gas transportation costs as well as electric power energy tariffs (which were the components for the production of ammonia and nitrogen mineral fertilizers) had increased. Due to these factors, KazAzot withdrew from signing long-term tri-partite natural gas supply contract. This therefore had nothing to do with the Republic. It should be noted that to date, the ammonia-carbamide project has not been implemented.

15.8 The Arbitral Tribunal should therefore disregard the terms of the unsigned Tri-Partite Agreement, particularly from a valuation point of view, given the extensive reliance of this agreement in the FTI Report (see para 5.21 to 5.34 of the FTI Report). The Claimants have failed to show that it has any relevance to this arbitration.

LPG Plant

15.9 As noted in paragraphs 14.15 to 14.16 above, the LPG plant was constructed pursuant to an agreement between TNG, Ascom and Vitol. In addition to demonstrating that the Claimants were responsible for only a small part of the investment in the LPG plant, the Vitol contract also shows that there was restrictions on supply to and sales from the LPG plant which would affect the value of the LPG plant.

15.10 TNG was obliged to sell all Products (i.e. what was produced from the LPG plant) to a joint venture between Vitol and Ascom unless those parties agreed otherwise (clause 3.2 and clause 5.3) pursuant to the terms of an off-take agreement. The joint venture company was then required to on-sell all Products to Vitol pursuant to a marketing services agreement.

15.11 From Clause 4.1 of the Joint Operating Agreement, it was Vitol and Ascom (as the Joint Management Committee) that were actually responsible for directing and controlling the business of the plant. TNG only had a peripheral operational role (see clause 3.2).

15.12 Vitol was to have a right of first refusal to enter into any contract for the supply of gas to the Plant (clause 7.2) and therefore was given favourable treatment in terms of supply and off-take.

- 15.13 Importantly, Vitol was entitled to 50% of the Net Profit of the plant (clause 5.1). Any potential income the Claimants could have made should be halved to reflect this.
- 15.14 KPM and TNG were obliged to supply all gas they produced to the LPG Plant (clause 8.8).
- 15.15 The agreement was for an initial 10 year period and was to be extended automatically on an annual basis thereafter unless a party gave 3 months notice prior to the end of the 10 year period or, if extended, the end of each consecutive following year.

16 The Claimants' Failure to attract interest for the sale of KPM and TNG / Project Zenith

- 16.1 The Claimants allege that their decision to sell arose in the Summer of 2008. On their own case, given that that the decision to sell occurred some months prior to the alleged start date of the alleged expropriation, the Claimants' motivations for sale cannot have had anything to do with the alleged expropriations. More likely, the Claimants' motivations centred on the problems that they were at that time facing in relation to water cut affecting gas production on the Tolwyn field, high oil prices (see 14.2 of Deloitte's Report), and the debts that they were facing in relation to the bonds (see paragraphs 5.9 to 9.64, 9.71 to 9.72 below).
- 16.2 As for the issue of water cut, the Republic's expert shows that this would have been a known problem from early 2008, so much so that they are surprised that the Claimants' experts appeared to have ignored the issue completely in their reports (GCA, pages 6 to 7).
- 16.3 To mask the illegalities of its purchase of KPM and TNG the Claimants failed to provide accurate information on how it came to own the companies and the various issues surrounding the transfers and re-organisations. This is clear from the exhibits the Claimants have disclosed alone which show that neither the Vendor Due Diligence (**Exhibit C-69**) nor the Information Memorandum (**Exhibit C-70**) gave sufficient information on the Claimants' purchase which enable bidders to come to the conclusion that the Claimants acquisitions were illegal, the various transfers of KPM and TNG was illegal, the reorganisation of TNG and KPM as LLP's was illegal, and the fact that they did not have licenses for use of subsurface resources and transportation of crude oil (see Paragraph 13 above).
- 16.4 In order to realize this project, the Claimants hired Renaissance Capital, an investment company.
- 16.5 In relation to the Contract 302 Properties, the Claimants assert that the asset was not included in the initial phase as they were still in the assessment stage (paragraph 69 of the SoD).
- 16.6 However, as noted at Paragraph 14.17 to 14.23 above, the available data showed so few provable reserves and such high development costs that the value of the 302 properties would be minimal. Whilst the Claimants pretend, on an entirely fictitious basis, that the market would ignore the risks associated with the 302 properties in establishing their value, the Republic's

more credible view, based on a proper commercial valuation conducted by experts, is that the 302 properties would be worth only \$69m on the open market. This valuation is in fact generous to the Claimants since on the facts Contract 302 had expired by the proper valuation date, rendering a market value of 0 for the properties.

- 16.7 The Claimants assert that they were disappointed with the offers procured in the first round of bids (paragraph 72 of the SoC). This had nothing to do with any action or inaction of the Republic and their decision in January 2009 to press ahead with the sale suggests there was no disappointment. Rather the assets were unattractive to potential purchasers for reasons unconnected to the Republic's actions. This can be seen from the Renaissance Capital Presentation to Ascom and Tristan (**Exhibit C-17**) giving an overview of the indicative offers. Pages 11 and 12 give an overview of why the majority of potential bidders decided not to make a bid and the reasons included:
- (a) the Global Economic Crisis;
 - (b) a perceived lack of transport links to the site;
 - (c) hikes in oil prices;
 - (d) the project being "too small";
 - (e) no geological upside in the;
 - (f) the project being too expensive.
- 16.8 In any event, the offers procured during the first phase of Project Zenith were indicative only (**Exhibit C-17**), were non-binding and were based on further due diligence and do not demonstrate accurately the value of the assets at the time (Deloitte CJ).
- 16.9 What seems to have actually happened was that only 8 potential bidders expressed any sort of interest (out of 129 contacted) and after a detailed examination of the proposal, none of them expressed interest to carry out further negotiations (paragraphs 185 -187 of the SoC).
- 16.10 This is clear from the fact that, during the Claimants second attempt to sell the companies, which commenced in January 2009 (paragraph 184 of the SoC), only 2 months after it "failed" to sell the first time round (the supposed "second phase of Project Zenith"), when the "potential bidders" were given further access to the data room (paragraph 186 of the SoC), they all decided to not take part in the process, with many of them making this decision almost immediately¹¹⁷. This was the case even though they decided to include the supposedly attractive Contract 302 Properties

¹¹⁷ Paragraph 186 of the SoC shows that Turkish Petroleum Corporation and PSA Energy Holding SPC dropped out after being given access to the data room.

(paragraph 184 of the SoC). Their decision to drop out of the sale process had nothing to do with the Republic. This can be seen as:

- (a) Of the 7 bidders which the Claimants' contacted as a result of them making indicative non-binding offers during the first phase of Project Zenith, 5 of them decided to not take part in the supposed second phase which commenced only 2 months later - without even looking at the data room (paragraph 185 of the SoC). Their independent decision to not take part had nothing to do with the Republic.
- (b) Of the 2 which remained (being Total and Turkish Petroleum Corporation) and the new bidder (PSA Energy Holding SPC) only Total expressed any interest (paragraph 187 of the SoC). It should be noted that in contrast, PSA Energy Holding SPC and Turkish Petroleum Corporation dropped out of the process immediately after they were given access to the data room in February 2009, which suggests that it had seen further and/or different information to what it had been given in the Information Memorandum and (**Exhibit C-70**) and Vendor Due-Diligence (**Exhibit C-69**). In particular, by this point it may have discovered the illegalities relating the Claimants' acquisitions and transfers of KPM and TNG (see section Paragraph 13 above).
- (c) On the Claimants' own case Total stated that it withdrew from the process for technical reasons (see paragraph 187 of the SoC). They have provided no evidence to support their belief that the Kazakh authorities discouraged Total from continuing the negotiation process and therefore the Republic strongly resist and inference that it had any role in Total's decision.
- (d) The Claimants also provide no evidence that KNOC withdrew from the process after speaking to the Kazakh authorities and the Arbitral Tribunal should therefore disregard its assertion that the Republic in any way discouraged KNOC from withdrawing from the process (paragraph 188 of the SoC).
- (e) Chronologically every bidder except Cliffson Company, the Kazakh owned Starleigh and the state owned KazMunaiGas withdrew from the process before KPM was legitimately fined USD145m in accordance with Kazakh law for operating a trunk pipeline by the Aktau City Court on 18 September 2009 (see Paragraph 27 below). It is difficult to see how any of the other alleged legal actions of the Republic would have impacted on a bidder's decision and therefore deterred them from making a bid. The reality was that the Claimants simply could not find anyone to buy the assets and this had nothing to do with the Republic.
- (f) All that the Claimants' analysis of the Starleigh and KazMunaiGas bids show is that, when taking into account the considerable debt owed to bondholders and the fact that KPM's and TNG's assets were tied in with such debt (considered above), together with

the legitimate fine imposed on KPM, the companies were not worth very much (if they were worth anything at all).

- (g) The Claimants have not given a breakdown of Cliffson Company's offer and therefore it is difficult to see the amount that would have been paid to buy out the companies bondholders' (as suggested in paragraph 193 of the SoC). The Claimants are put to proof as to the amount (Cliffson Company would have paid for the equity interests given that, as set out in paragraph 9.59, USD531million worth of bonds had been issued and the companies were in debt as a result of their violations of Kazakh law and the contracts and licences.
- (h) In relation to Cliffson Company, the Claimants have also not provided:
 - (i) Its application for permission that the Republic waive its pre-emptive right to purchase;
 - (ii) The Republic's response (it has referred to an alleged statement the Ministry of Oil and Gas (**MOG**) made at paragraph 194 of the SoC regarding the removal of attachment orders but has not provided the actual document and therefore this alleged statement should be ignored by the Tribunal);
 - (iii) The Republic's alleged request for information and materials (asserted at paragraph 194 of the SoC) including about the financial solvency of Cliffson Company, as well as its technical and managerial capabilities;
 - (iv) The Claimants alleged presentation of the materials and information requested by the MOG (asserted at paragraph 194 of the SoC); and
 - (v) Cliffson Company's decision to withdraw from the deal.

The Claimant has therefore not proved that any of these events occurred let alone that they occurred in the manner alleged.

- (i) The Arbitral Tribunal should also note that the fact that the Claimants failed to obtain the waiver of the Republic's pre-emptive rights was identified by Cliffson Company only further shows that the Claimants did not obtain this waiver when it should have done. Cliffson Company requested that this waiver was obtained and permission be received. The Claimants' were, as a result of the illegalities set out above, unable to get permission so the transaction was bound to fall through.

16.11 In relation to the Claimants decision to include the Contract 302 Properties when it approached potential bidders in January 2009, notwithstanding its alleged value the Claimants still failed to attract significant interest from bidders, nor did they achieve bids within the range of values they

hoped for. It is therefore difficult to see how the Claimants can justifiably argue that these properties had the sort of value which they claim it did. Taking into account the assessment of the Republic's expert as to the prospects of finding considerable commercially exploitable reserves on the 302 properties, it is hardly surprising that the addition of this asset to the Claimants' offer failed to ignite the market (paragraph 16 of the GCA Report).

17 Alleged harassment campaign

- 17.1 At paragraphs 74 to 179 of the Statement of Claim, the Claimants allege that a number of constitute indirect expropriation of the Claimants' assets (namely the pre-emptive rights issue, tax and customs audits, issues surrounding the Contract 302 exploration period, criminal actions and fines, and enforcement measures in relation to such criminal actions).
- 17.2 In relation to each of these issues, it is the Republic's position that it acted in accordance with the law and that its actions did not form part of any premeditated harassment campaign.
- 17.3 In any event, the Claimants have failed to adequately demonstrate or particularise what effect, if any, these actions had on the Claimants' investments. As set out above, the burden of proof remains on the Claimants to assist the Arbitral Tribunal to the grounds on which any of the actions taken by the Republic in relation to these issues are relevant to any of the Claimants' investments. It is insufficient to assert that this is "self-evident" (as asserted by the Claimants at paragraph 180 of the Statement of Case).
- 17.4 The Republic's position in relation to each alleged event of indirect expropriation is set out below at Section 17 to Section 30. The waiver of pre-emptive rights and the expiry of contract 302 is set out at Section 13 above.

18 There was no conspiracy against the Claimants: The President's Order of October 2008, the letter of the Governor of Mangystau Region dated 26 August 2009, the letter from the MEMR dated 28 September 2009 and Letter of the President of the Blagovest Fund dated 7 February 2010

THE REPUBLIC'S ANALYSIS

Subject-matter of the Claimants' statement

- 18.1 The Claimants' state (see paragraph 75 of the Statement of Claim) that the campaign of Kazakhstan for indirect expropriation of its Investments was launched on 14 October 2008 when the President of the Republic of Kazakhstan N. Nazarbayev instructed Deputy Prime-Minister of Kazakhstan U. Shukeev and the Head of Financial Police S. Kalmurzaev to conduct an "extensive investigation" of all its business operations in the Republic of Kazakhstan.

- 18.2 In paragraph 271 of the Statement of Claim it is stressed that “the campaign of Kazakhstan for indirect expropriation of its Investments was launched on 14 October 2008 when the President of the Republic of Kazakhstan N. Nazarbayev personally instructed the Financial Police of Kazakhstan and a number of other state bodies “to conduct an in-depth study” of business operations of the Claimants in Kazakhstan. The Financial Police and seven other agencies started the prosecution campaign”.
- 18.3 This “instruction for expropriation” was given in the form of a resolution on the letter received from the President of the Republic of Moldova (**Exhibit C-78**). Moreover, allegedly it was the President of the Republic of Kazakhstan who initiated this letter (**Exhibit C-78, TV-interview, time 01:10:59**). The Claimant asserts that the President of the Republic of Kazakhstan “leapt” at the letter of the President of the Republic of Moldova under the pretext of launching the “prosecution campaign” (paragraphs 75 and 78 of the Statement of Claim).
- 18.4 The fact that nationalization of the Claimant’s Investments became a state goal in 2008 is allegedly confirmed by the Letter of the “Blagovest” Social Foundation (paragraph 15 of the Statement of Claim).

Instruction of the President of the Republic of Kazakhstan

- 18.5 Subject-matter of the letter and the instruction
- (a) On 6 October 2008 the President of the Republic of Moldova wrote a letter to the President of the Republic of Kazakhstan (**Exhibit C-77**).
 - (b) The letter contains information about the **bad faith** (the English translation of this word is incorrect) of the Claimant’s activity of the Moldavian businessman A. Stati in the territory of Kazakhstan. The President of Moldova communicates that the business of A. Stati “has nothing Moldavian except for the place of birth of the business itself”. Further the President of the Republic of Moldova warns the President of the Republic of Kazakhstan that A. Stati channels the revenues received in Kazakhstan for making investments in the territories exposed to the UN sanctions, conducts “blood business”. This causes damage to both the country where it derives profit and the home country of the businessman. Concluding the letter the President of the Republic of Moldova notes that Stati lately proceeded to formation in Moldova of “a corrupt lobby and interferes into the personnel and external policy of Moldova”.
 - (c) The letter had the resolution of the President of the Republic of Kazakhstan. Its translation from the Russian into the English language is presented the **Exhibits C-8.2 and C-8.1**. The text of the resolution in the Russian language:
 - (d) «По просьбе молдавской стороны тщательно проверить работу компании и **решать его дальнейшую работу в интересах страны**» (At the request of the Moldavian

party to carry out a thorough inspection of the company activity and **to decide on his further operation in the interests of the country**).

- 18.6 The first part of the instruction: "At the request of the Moldavian party to carry out a thorough inspection of the company operation"
- (a) Passing of a resolution is governed by document management rules of state bodies of the Republic of Kazakhstan. In this case the letter of the President of Moldova addressed to the President of the Republic of Kazakhstan is concerned. Hence its consideration by the addressee and passing of a respective resolution as provided for by the effective legislation of the Republic of Kazakhstan falls within the competence of the President of Kazakhstan.
 - (b) Taking into account that in his letter the President of Moldova negatively describes the activity of A. Stati as bad faith, corrupt and inconsistent with international law, the President of the Republic of Kazakhstan gave within his competence the respective instruction in the form of a resolution on the letter of the President of Moldova.
 - (c) What kind of instruction in respect of the letter of the President of Moldova should the President of Kazakhstan have given in the opinion of the Claimant? "Don't believe the address of the President of Moldova", "Do not conduct any inspections of the companies "Kazpolmunay" and "Tolkynneftegaz" and the activity of A. Stati"?
 - (d) Such instruction would be contrary to the requirements of national legislation of the Republic of Kazakhstan and its obligations based on international treaties which will be discussed below.
 - (e) It should be noted that on 4 November 1992 the Treaty on Mutual Understanding and Cooperation between the Republic of Kazakhstan and the Republic of Moldova was signed in the city of Almaty (ratified by the ruling of the Supreme Council of the Republic of Kazakhstan on 19 October 1993 N 2455-XII, in effect since 9 October 1996) (hereinafter the Treaty) **(Exhibit R-106)**.
 - (f) In accordance with Article 3 of the Treaty "High Contracting Parties shall prohibit and prevent in accordance with its legislation the creation and activity in its territories of organizations and groups as well as the actions of other persons aimed against independence, territorial integrity of each of the states or at escalation of inter-national relations".
 - (g) Hence, by virtue of international obligations of the republic of Kazakhstan and within the legislative powers of the President of the Republic of Kazakhstan the President of the Republic of Kazakhstan gave the lawful instruction to inspect the activity of the companies of "Kazpolmunay" and "Tolkynneftegaz" belonging to A. Stati.

- (h) The instruction to inspect the activity of the companies of “Kazpolmunay” and “Tolkynneftegaz” was given to the Deputy Prime-Minister of the Republic of Kazakhstan who supervised the issues of subsoil use and to the Head of Financial Police of the Republic of Kazakhstan (**Exhibits C-8.2 and C-8.1**).
- (i) Taking into account that the Government as a collective body at the head of the executive power and the Financial Police of the Republic of Kazakhstan are directly subordinated and report to the President of the republic of Kazakhstan there is no doubt that the instruction to inspect the activity of the companies of “Kazpolmunay” and “Tolkynneftegaz” could be and was indeed given exactly to the above mentioned officials.
- (j) According to sub paragraph. 7 paragraph1 Article 8 of the Law of the Republic of Kazakhstan “On the Bodies of the Financial Police” as in force on the date of the instruction of the President of the Republic of Kazakhstan, the bodies of the Financial Police in line with the set tasks within their powers **are obliged to prevent, identify and suppress economic, financial and corruption-related crimes and offences (Exhibit R- 113)**.
- (k) By virtue of sub paragraph. 9) paragraph 1 Article 8 of the said Law as in force on the date of the instruction of the President of the Republic of Kazakhstan, the bodies of the Financial Police for the purpose of fulfillment of the tasks imposed on them are **entitled to demand**, within their powers and in accordance with the procedure established by law, **from the authorized bodies and officials to carry out** revisions, **inspections**, audit and assessment **in cases provided for by the legislation of the Republic of Kazakhstan (Exhibit R- 113)**.
- (l) Thus, paragraph 7 of the Regulations on Performance of state registration, statistical accounting and control over inspections carried out by state bodies of the Republic of Kazakhstan approved by the Decree of the Prosecutor General of 14 November 2007 №46, as in force on the date of the instruction of the President of the Republic of Kazakhstan, enumerates the types of inspections among which, inter alia, is the **unscheduled inspection ordered by a state body in pursuance of instructions** or inquiries **of the President of the Republic of Kazakhstan**, the Government of the Republic of Kazakhstan, General Prosecutor’s Office, other state bodies and officials authorized to give instructions and file inquiries as well as by virtue of the necessity to prevent violations of the legislation subject to existence of an actual threat to health and life of people, preservation of property and emergency situations (**Exhibit R-114**).
- (m) Therefore, when carrying out and ordering the inspections the Financial police of the Republic of Kazakhstan acted in strict compliance with the then effective legislation of the Republic of Kazakhstan.

- (n) Besides, it should be taken into account that in 2008 the Republic of Kazakhstan participated in all major treaties on combating legalization of illegally gained income and terrorism.¹¹⁸
- (o) The Republic of Kazakhstan also participated in the activity of a number of international organizations aimed at combating legalization of criminal income, corruption and terrorism (Eurasian Group on Combating Money Laundering and Terrorism Financing – EAG, EGMONT Group, International Organization of criminal Police “Interpol”).
- (p) The instruction of the President of the Republic of Kazakhstan to inspect the activity of the company can not be interpreted as the instruction to make expropriation. Such cause-and-effect relation was not proved by the Claimant.

18.7 The second part of the phrase: “to determine its further operation in the interests of the country”

- (a) If one proceeds from the Russian text the second part of the phrase does not concern the companies (legal entities) at all. It concerns the permission which should be issued to a natural person whose name is not indicated for carrying out the activity in the interests of the country.
- (b) This part of the phrase is incorrectly translated into the English language. It sounds as follows: “to determine its further operations in the best interest of the country” (Exhibit C-8.1)
- (c) In the Russian text (and the Russian text of the resolution is submitted as the original) there is neither the word its, nor the word best. The word «решать» is translated as to «determine». This is one of the possible options of translation of the word решать, however it is impossible in the present context (taking into account that there is no word its in the Russian text).
- (d) The literal translation of the second part of the letter is “to permit his further activity in the interests of the country”.
- (e) The word “its” «его» (*masculine gender*) may in no way be attributed to the legal entity (in this case one should have used the word “ее” – the company (it is feminine gender in Russian)). We assume that the second part of the resolution was obvious for the

¹¹⁸Vienna Convention on Combating Illicit Drug Trafficking and Psychotropic Substances of 1988 (ratified by the Republic of Kazakhstan on 29 June 1998); New York Convention on Combating Terrorist Financing of 1999 (ratified by the Republic of Kazakhstan on 2 October 2002); Palermo Convention against Transnational Organized Crime of 2000 (ratified by the Republic of Kazakhstan on 4 June 2008); Shanghai Convention on Combating Terrorism, Separatism and Extremism dated 15 June 2001 (ratified by the Republic of Kazakhstan on 18 April 2002); UN convention against Corruption of 31 October 2003 (ratified by the Republic of Kazakhstan on 4 May 2008). CIS Agreement on Combating Terrorism of 4 June 1999 (ratified

President of the Republic of Kazakhstan and for those to whom it referred not by virtue of the letter but rather by virtue of some other documents or oral conversations. The fact that it does not refer to the company is evident. As was noted earlier, the activity of the businessman A.Stati is characterized in the letter of the President of the Moldova extremely negatively. It is described as “corrupt”, “blood business”, that “there is nothing Moldavian in his business but for the place of birth of the businessman itself”, etc.

- (f) In its turn, in the opinion of the Respondent, the second part of the phrase obviously refers to Mr. A. Stati, since it was his unlawful activity which was the subject-matter of the letter from the President of Moldova.
- (g) At the same time the ground for such instruction of the President of the Republic of Kazakhstan is also the requirement of the rule in Article 3 of the Treaty (**Exhibit R-106**).
- (h) Further, Article 14 of the Treaty sets forth that the “High Contracting Parties shall expand and deepen their cooperation in combating criminality, terrorism, drug addiction as well as illegal drug trafficking, weapons and smuggling”. (**Exhibit R-106**).
- (i) Taking into account the fact that the letter of the President of the Republic of Moldova contains information to the effect that “A. Stati proceeded to formation in Moldova of a corrupt lobby and interferes into the personnel and external policy of Moldova” (Exhibit C-77), the President of the Republic of Kazakhstan gave such instruction basing on international obligations of the Republic of Kazakhstan and its national interests.
- (j) According to Article 40 of the Constitution of the Republic of Kazakhstan, the President of the Republic of Kazakhstan is the head of the state, its senior official determining principal directions of domestic and foreign policy of the state and representing Kazakhstan inside the country and in international relations (Exhibit R-91).
- (k) At the same time we would like to emphasize that the word “decide” does not mean at all “to prohibit”, “to bring to an end”. Here the word “to decide” may be interpreted in the broadest sense, so as to include the words “to check”, “to examine”, since the letter about the illegal activity of A. Stati was received from the first person of the state.
- (l) In other words the visa cited by the Claimant may be interpreted as “to consider further work of A. Stati in the interests of the country”.
- (m) So, what we have here is a distortion of the translation of the document which is of primary importance for the case in a manner which seemed convenient to the Claimants. In such a way the “legend” about “the instruction for nationalization” came into being.

- (n) Moreover, it should be noted that based upon the results of the inspections and preliminary investigation by the Financial Police bodies A. Stati was not held liable under the legislation of the Republic of Kazakhstan.
- (o) The Claimant's assertion related to expropriation of its investments in Kazakhstan is false and does not correspond to reality, just like the indication at the initiative of the President of the Republic of Kazakhstan in this issue.
- (p) Moreover, it is absurd that the Head of the state will apply for help to the Ministry which directly report to it through the social foundation giving the instruction to Zakharov Yu.F.
- (q) At the same time it should be noted that the second instruction of the President of the Republic of Kazakhstan of 19 November 2009 (Exhibit C-23) rebuts the arguments of the Claimant about expropriation, since in that instruction the President of the Republic of Kazakhstan points at the inadmissibility of production shutdown at the enterprises TOO "Tolkynneftegaz", "Borankol Gas Treatment Plant", TOO "Kazpolmunay", TOO "KASKO" and the company "Caspian Gas Corporation" in connection with the conducted inspections.

The President of the Republic of Kazakhstan did not initiate the letter of the President of the Republic of Moldova

Point of the Claimant's assertion

- 18.8 In its Statement of Claim the Claimant notes that the letter of the President of Moldova was allegedly drawn up at the request of the President of the Republic of Kazakhstan. Further it is concluded that the President of the Republic of Kazakhstan initiated himself the prosecution campaign of the Claimant in Kazakhstan.

Analysis of the interview of Voronin

- 18.9 If one believes the TV-interview of the former President of the Republic of Moldova V. Voronin **(time 01:10:59, Exhibit C-78)** at one of the summits the President of the Republic of Kazakhstan asked him to send him the information of a Moldavian businessman. The name of Stati was not mentioned but it was implied that Stati was concerned.
- 18.10 This request was expressed in the Russian language and cited in the Rumanian text of the TV-interview also in Russian **(Exhibit C-78.2)**. Its English translation is incorrect and the context in which it is used tendentious.

- 18.11 In the Russian text the phrase “There by you works **such** businessman”. The use of the word “such” without indication of the name in the Russian language usually means the characteristic of a person (such a businessman!). From the English text the word “**such**” is missing.
- 18.12 In general the fact presented by the President of the Republic of Moldova in his TV-interview raises some doubts. After all the President of the Republic of Moldova does not remember the content of the letter (**time 01:14:04, Exhibit C-78**), he states that the Administration of the President has over 30 million documents (**time 01:12:33, Exhibit C-78**) and he is not obliged to know all of them. But at the same time he remembers the request of the President of the Republic of Kazakhstan to write this letter.
- 18.13 But even if such a conversation indeed took place, what does it demonstrate?
- 18.14 The President of the Republic of Kazakhstan asked to send him the information about some businessman known to him. Can such a kind of request be considered as the prosecution campaign launched by the President of the Republic of Kazakhstan? There are no grounds for this. The Claimant has not proved the cause-and-effect relation between this conversation and the alleged prosecution. After all, a contrary conclusion can be drawn from this request. Perhaps, to the contrary, the President of the Republic of Kazakhstan was interested in the investments into Kazakhstan on the part of Stati and just wanted to make sure that this is a worthy businessman. This meaning is only excluded by the incorrect translation of the words of the President of the Republic of Moldova which he said in the interview in the Russian language, in particular the omission of the word “such” from the translation.

Opinion of the Social Foundation “Blagovest”

- 18.15 What is the Social Foundation “Blagovest”? It is one of the thousands of non-commercial organizations existing in the territory of Kazakhstan. According to the information of the Ministry of Justice of the Republic of Kazakhstan, at present 5772 non-governmental foundations are registered in the territory of the Republic of Kazakhstan (**Exhibit R-116**).
- 18.16 A social foundation is not a governmental organization. It acts in accordance with paragraph 1 Article 107 of the Civil Code of the Republic of Kazakhstan (**Exhibit R-8**) and paragraph 1 article 12 of the Law of the Republic of Kazakhstan “On Non-Commercial Organizations” (hereinafter – the Law) (**Exhibit R-117**). This is a non-membership, non-commercial organization created by individuals and (or) legal entities on the basis of voluntary contributions of assets and pursuing social, charitable, cultural, educational and other socially useful objectives. By virtue of paragraph 4 Article 12 of the Law as a social foundation shall be recognized a foundation established by natural persons which are not members of one family and (or) legal entities – public associations. The property of a social foundation shall be formed out of one-time and (or) regular contributions of legal entities – public associations and natural persons, as well as from other sources provided for by Article 35 of the Law and corresponding to the goals of activity of a social foundation.

- 18.17 “Blagovest” Foundation applied to the Minister of energy and Mineral Resources of Kazakhstan with the offer to assist in solving problematic issues connected with the companies “Kazpolmunay” and “Tolkynneftegaz” (**Exhibit C-23**). Basing on the testimonial evidence the head of the Foundation Zakharov (**Exhibit R-178**) had no clear idea of what he was offering in the application signed by him. He was approached by the former Director of the company “Kazpolmunay” G.V. Andreev who decided to earn money acting as a mediator between Kazakhstan and Stati in solving the existing situation. Zakharov signed the application prepared by Andreyev who had promised to him to provide financing in consideration of this service.
- 18.18 According to oral information provided by Andreev Zakharov understood that the property of Stati was transferred to the labour collective and it was exactly in this meaning that he used the word nationalization. As for the rest he was not familiar with the situation at all.
- 18.19 In view of the aforesaid the opinion of the Foundation in this case as a private opinion of a private person should be taken into account by the court.
- 18.20 Conclusion: the arguments of the Claimant in respect of initiation by the President of the Republic of Kazakhstan of the prosecution campaign against the Claimant are false. They are based on the juggling with facts, in particular on incorrect attribution of relevance to ordinary facts, on the inaccurate translations of documents from the Russian into the English language as well as on the attempt to see the cause-and-effect relation there where it does not exist.

19 Inspections

Claimant’s arguments

- 19.1 The arguments of the Claimant in respect of inspections of the companies “Kazpolmunay” and “Tolkynneftegaz” by state bodies are presented in paragraphs 11, 76- 78 of the Statement of Claim with reference to testimonial evidence of Alexander Kozhin and Viktor Romanosov.
- 19.2 Basing on paragraph 11 of the Statement of Claim on 14 October 2008 the President of the Republic of Kazakhstan instructed the Deputy Prime-Minister of the Republic of Kazakhstan and the Head of the Financial Police to initiate inspections of the Claimant’s activity following which the Financial Police initiated various inspections of the activity of the companies “Kazpolmunay” and “Tolkynneftegaz”.
- 19.3 According to paragraph 77 of the Statement of Claim these inspections were “unprecedented”. The senior management spent most of its time answering to the inquiries of state bodies. As the former General Director of “Tolkynneftegaz” and Representative of General Director of “Kazpolmunay” Mr. Alexander Kozhin declares: he became the witness of how “Kazpolmunay” LLP and “Tolkynneftegaz” LLP turned from fully operative and functional oil and gas producing companies into two bodies which existed for the purpose of answering to the inquiries of different governmental officials and drawing up the reports. This process began approximately in

November of 2008 and continued for almost two years. Basing on the testimonial evidence of Viktor Romanosov in the past the inspections were carried out once a year and now their number has increased up to once in a quarter. He declares that he had spent much time for the meetings with state officials and this kept him away from his work.

- 19.4 In order to get a true idea of the existing situation two questions should be answered:
- (a) Has the state the right to inspect the activity of the companies “Kazpolmunay” and “Tolkynneftegaz”?
 - (b) Whether the inspections of the companies “Kazpolmunay” and “Tolkynneftegaz” carried out in the period from 2008 till 2010 fell beyond the scope of regular average statistical inspections?

Has the state the right to inspect the activity of the companies “Kazpolmunay” and “Tolkynneftegaz”?

- 19.5 Basing on Article 1 (6) (f) of the ECT under investment is meant any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector (**Exhibit C-1**).
- 19.6 The Investor should carry out its activity in the Republic of Kazakhstan on the basis of licenses and contracts for subsoil use (Contract № 305, License MG 309-D in effect since 23 May 1997;¹¹⁹ Contract № 210, License MG №242-D, in effect since 4 December 1997;¹²⁰ Contract №302, License MG №243-D in effect since 4 December 1997¹²¹). The license has a priority and the contract can not contradict it (see paragraph 32.5 of Contract № 305, as well as paragraph 27.5 of Contracts № 302 and № 210). In all licenses it was fixed in the column “Control Procedure” (paragraph11) that **the control over the activity of the Investor shall be exercised by state supervisory bodies in accordance with the legislation of the Republic of Kazakhstan.**
- 19.7 Any right has a corresponding obligation. Having acquired the right to subsoil use in accordance with the contracts, the Investor should have proceeded from the fact that when exercising this right it becomes the subject of the legislation of the Republic of Kazakhstan in the sphere of control over the activity of subsoil users.
- 19.8 The Code of Administrative Offences of the Republic of Kazakhstan in force since 2001 covers over 450 offences. The right to carry out inspections and the right to bring to responsibility is vested with 55 state bodies. Besides the right to bring to responsibility upon the results of

¹¹⁹ **Exhibit C -45.**

¹²⁰ **Exhibit C-52.**

¹²¹ **Exhibit C-53.**

inspections was granted also to the courts (**Exhibit R-118 – Letter of the General Prosecutor’s Office of the Republic of Kazakhstan**).

Whether the inspections of the companies “Kazpolmunay” and “Tolkynneftegaz” carried out in the period from 2008 till 2010 fell beyond the scope of regular average statistical inspections?

- 19.9 Any inspection is burdensome even if it is conducted one a year. At the same time when concluding a contract the Investor should realize that he automatically becomes subject to an average statistical number of inspections.
- 19.10 According to the legislation of the Republic of Kazakhstan in effect in the period from 2001 till 2010,¹²² the act on ordering an inspection is registered with the state body on a mandatory basis which carries out within its competence a statistical activity in the sphere of legal statistics and special accounting. In accordance with sub paragraph. 12 Article 4 of the Law of the Republic of Kazakhstan “On Prosecutor’s Office” such body in the Republic of Kazakhstan is the prosecutor’s office (**Exhibit R-126**).
- 19.11 **Exhibit R-118** contains the analysis of inspections carried out by state bodies in particular, in respect of “Kazpolmunay” LLP and “Tolkynneftegaz” LLP, prepared by the General Prosecutor’s Office of the Republic of Kazakhstan.
- 19.12 The conducted analysis of statistical data refutes the arguments of the Claimant on the unprecedented character of the inspections undertaken by state bodies in respect of the companies “Kazpolmunay” and “Tolkynneftegaz”. To illustrate, on the basis of official information on the inspections of subsoil users of Mangystau region for a period from 2001 till 2010 “Emir Oil” was inspected 76 times, “Kazpolmunay” LLP – 88 times, “Tolkynneftegaz” LLP - 100 times, “Karazhanbasmunai” - 246 times, “Mangistaumunaigaz” - 298 times, “Uzenmunaigaz” - 390 times.

¹²² Order of the Prosecutor General of the Republic of Kazakhstan of 29 December 2000 № 66 “On Approval of the Rules “On the Procedure of submission and registration of documents of primary accounting of all inspections of the activity of economic entities” and cancellation of the Order of the Prosecutor General of the Republic of Kazakhstan № 83 of 29 September 1999” (**Exhibit R-119**),

Order of the Prosecutor General of the Republic of Kazakhstan of 25 April 2002 № 27 “On Approval of the Rules “On the Procedure of submission and registration of documents of primary accounting of all inspections of the activity of economic entities” and cancellation of the Order of the Prosecutor General of the Republic of Kazakhstan № 66 of 29 December 2000” (**Exhibit R-120**)

Order of the Prosecutor General of the Republic of Kazakhstan of 1 March 2004 № 1 “On Approval of the Guideline to accounting of inspections of the activity of economic entities” (**Exhibit R-121**),

Order of the Prosecutor General of the Republic of Kazakhstan of 14 November 2007 № 4 “On Approval of the Guideline to state registration, statistical accounting and control over inspections conducted by state bodies of the Republic of Kazakhstan” (**Exhibit R-122**),

Order of the Prosecutor General of the Republic of Kazakhstan of 24 December 2009 № 71 “On Approval of the Guideline to uniform state registration, accounting and control over inspections conducted by state bodies of the Republic of Kazakhstan” (**Exhibit R-123**),

The Law of the Republic of Kazakhstan “On Protection and Support of Private Entrepreneurship” (**Exhibit R-124**),

The Law of the Republic of Kazakhstan “On Private Entrepreneurship” (**Exhibit R-125**).

- 19.13 In 2008 exposed to inspections were: “Kazpolmunay” LLP - 6 times, “Emir Oil” – 9 times, “Tolkynneftegaz” LLP - 11 times, “Karazhanbasmunai” - 13 times, “Mangistaumunaigaz” - 24 times, “Uzenmunaigaz” - - 77 times.
- 19.14 “Uzenmunaigaz” indirect interest in which is held by a national (state) company was inspected much more frequently than “Kazpolmunay” LLP and “Tolkynneftegaz” LLP.
- 19.15 Despite the transfer into trust management to a national company of the Claimant’s assets the trust manager – the branch “Offshore Oil Company “KazMunaiTeniz”JSC – was exposed three times to inspections by state bodies as of the end of August 2011.
- 19.16 Summing up one should note that all inspections to which the companies “Kazpolmunay” and “Tolkynneftegaz” were exposed were carried out in accordance with the legislation of the Republic of Kazakhstan and stayed within the limits of average statistical inspections in the region.

FURTHER ANALYSIS

- 19.17 As may be seen from the Claimants’ case concerning indirect expropriation they rely heavily on the Tribunal adopting their belief that the various audits, inspections, tax assessments prosecutions and ultimate termination of KPM and TNG’s subsoil contracts were all part of a grand scheme set in motion by the Republic with the sole objective of expropriating the Claimants’ investments.
- 19.18 As the Republic will demonstrate over the following sections of this document, any such belief is unjustified. What the Claimants describe in florid terms as coordinated actions of an oppressive state with a single minded goal of expropriation are, in fact, unremarkable operations of state bodies of powers to inspect KPM and TNG and the subsequent prosecutions of offences revealed by those inspections.
- 19.19 Aside from the hyperbole in their description of the actions of the various state bodies concerned, the Claimants rely substantially on a number of communications from or to senior politicians, in their attempt to prove that the routine exercise and pursuit of administrative functions by state officials was in fact the sinister machinations of a state-wide conspiracy against the Claimants.
- 19.20 Those communications are:
- (a) The letter from President Voronin of Moldova to President Nazarbayev of Kazakhstan dated 6 October 2008 (**Exhibit C-77**);
 - (b) The Order of President Nazarbayev dated 16 October 2008 (**Exhibit C-8**);

- (c) The letter of the Governor Mangystau Region to the Prime Minister of Kazakhstan dated 26 August 2009 (**Exhibit C-293**);
- (d) Letter from the MEMR to the Ministry of Industry and Trade dated 28 September 2009 (**Exhibit C-294**);
- (e) The letter from the President of the Blagovest Fund to the MEMR dated 7 February 2010 (**Exhibit C-23**).

19.21 In relation to the letter of President Voronin:

- (a) The letter contains information about the bad faith (the English translation of this word is incorrect) of the Claimants' activity of the Moldavian businessman Anatolie Stati in the territory of Kazakhstan. The President of Moldova states that the business of Anatolie Stati "*has nothing Moldavan except for the place of birth of the business itself*". Further, the President of the Republic of Moldova warns the President of the Republic of Kazakhstan that Anatolie Stati channels the revenues received in Kazakhstan for making investments in the territories exposed to the UN sanctions, conducts "*bloody business*". He goes on to say this causes damage to both the country where it derives profit and the home country of the businessman. Concluding the letter, the President of the Republic of Moldova notes that Stati recently proceeded to form in Moldova "*a corrupt lobby and interferes into the personnel and external policy of Moldova*".
- (b) If one believes the TV interview of the former President of the Republic of Moldova V. Voronin (time 01:10:59, **Exhibit C-78**), at one of the summits the President of the Republic of Kazakhstan asked him to send him the information of a Moldovan businessman. The name of Stati was not mentioned but it was implied that Stati was concerned.
- (c) This request was expressed in the Russian language and cited in the Romanian text of the TV interview, also in Russian (**Exhibit C-78.2**). Its English translation is incorrect and the context in which it is used tendentious.
- (d) In the Russian text the phrase is "*There by you works such businessman*". The use of the word "*such*" without indication of the name in the Russian language usually means the characteristic of a person (such a businessman). From the English text the word "*such*" is missing.
- (e) In general the fact presented by the President of the Republic of Moldova in his TV interview raises some doubts. After all the President of the Republic of Moldova does not remember the content of the letter (time 01:14:04, **Exhibit C-78**), he states that the Administration of the President has over 30 million documents (time 01:12:33, **Exhibit C-**

78) and he is not obliged to know all of them. But at the same time he remembers the request of the President of the Republic of Kazakhstan to write this letter.

- (f) But even if such a conversation indeed took place what does it demonstrate?
- (g) The President of the Republic of Kazakhstan asked him to send the information about some businessman known to him. This is not evidence of an intention to undertake a campaign of harassment leading to expropriation. There are no grounds for this. The Claimants have not proved the cause-and-effect relation between this conversation and the alleged prosecution. After all, a contrary conclusion can be drawn from this request. Perhaps, to the contrary the President of the Republic of Kazakhstan was interested in the investments into Kazakhstan on the part of Stati and just wanted to make sure that he is a worthy businessman. In order to exclude such interpretation the Claimants appear to have incorrectly translated the words of the President of the Republic of Moldova which he said in the interview in the Russian language by omitting the word "such" from the translation.

19.22 In relation to the Order of President Nazarbayev dated 16 October 2008 (**Exhibit C-8**):

- (a) In SoC para 271 it is stressed that *"Kazakhstan's campaign of indirect expropriation commenced on 14 October 2008 when President Nazarbayev personally ordered the Kazakh Financial Police and a variety of other Governmental agencies to 'fully investigate 'Claimants' business activities in Kazakhstan'. The Financial Police and seven other ministries and agencies started their harassment campaign in earnest of the heels of President Nazarbayev's direction."*
- (b) Passing of a resolution is governed by document management rules of state bodies of the Republic of Kazakhstan. In this case, the letter of the President of Moldova addressed to the President of the Republic of Kazakhstan is concerned. Hence its consideration by the addressee and passing of a respective resolution as provided for by the effective legislation of the Republic of Kazakhstan falls within the competence of the President of Kazakhstan.
- (c) Taking into account that in his letter the President of Moldova negatively describes the activity of Anatolie Stati as bad faith, corrupt and inconsistent with international law, the President of the Republic of Kazakhstan gave within his competence the respective instruction in the form of a resolution on the letter of the President of Moldova.
- (d) For President Nazarbayev to ignore such information would be contrary to the requirements of national legislation of the Republic of Kazakhstan and its obligations based on international treaties which will be discussed below.

- (e) It should be noted that on 4 November 1992 the Treaty on Mutual Understanding and Cooperation between the Republic of Kazakhstan and the Republic of Moldova was signed in the city of Almaty (ratified by the ruling of the Supreme Council of the Republic of Kazakhstan on 19 October 1993 N 2455-XII, in effect since 9 October 1996) (hereinafter the Treaty) (**Exhibit R-106**).
- (f) In accordance with Article 3 of the Treaty *“High Contracting Parties shall prohibit and prevent in accordance with its legislation the creation and activity in its territories of organizations and groups as well as the actions of other persons aimed against independence, territorial integrity of each of the states or at escalation of inter-national relations”*.
- (g) Hence, by virtue of international obligations of the Republic of Kazakhstan and within the legislative powers of the President of the Republic of Kazakhstan, the President of the Republic of Kazakhstan gave the lawful instruction to inspect the activity of the companies of KPM and TNG belonging to Anatolie Stati.
- (h) The instruction to inspect the activity of KPM and TNG was given to the Deputy Prime-Minister of the Republic of Kazakhstan who supervised the issues of subsoil use and to the Head of Financial Police of the Republic of Kazakhstan (**Exhibit C-8**).
- (i) Taking into account that the Government as a collective body at the head of the executive power and the Financial Police of the Republic of Kazakhstan are directly subordinated and report to the President of the republic of Kazakhstan there is no doubt that the instruction to inspect the activity of KPM and TNG could be and was indeed given exactly to the above mentioned officials.
- (j) According to subparagraph 7 paragraph 1 Article 8 of the Law of the Republic of Kazakhstan *“On the Bodies of the Financial Police”* as in force on the date of the instruction of the President of the Republic of Kazakhstan, the bodies of the Financial Police in line with the set tasks within their powers are obliged to prevent, identify and suppress economic, financial and corruption-related crimes and offences (**Exhibit R-113**).
- (k) By virtue of subparagraph 9 paragraph 1 Article 8 of the said Law as in force on the date of the instruction of the President of the Republic, the bodies of the Financial Police for the purpose of fulfilment of the tasks imposed on them are entitled to demand, within their powers and in accordance with the procedure established by law, from the authorized bodies and officials to carry out revisions, inspections, audit and assessment in cases provided for by the legislation of the Republic (**Exhibit R- 113**).

- (l) Thus, paragraph 7 of the Regulations on Performance of state registration, statistical accounting and control over inspections carried out by state bodies of the Republic approved by the Decree of the Prosecutor General of 14 November 2007 №46, as in force on the date of the instruction of the President of the Republic of Kazakhstan, enumerates the types of inspections among which, inter alia, is the unscheduled inspection ordered by a state body in pursuance of instructions or enquiries of the President of the Republic of Kazakhstan, the Government of the Republic of Kazakhstan, General Prosecutor's Office, other state bodies and officials authorized to give instructions and file inquiries as well as by virtue of the necessity to prevent violations of the legislation subject to existence of an actual threat to health and life of people, preservation of property and emergency situations (**Exhibit R-114**).
- (m) Therefore, when carrying out and ordering the inspections the Financial Police of the Republic of Kazakhstan acted in strict compliance with the then effective legislation of the Republic of Kazakhstan.
- (n) Besides, it should be taken into account that in 2008 the Republic of Kazakhstan participated in all major treaties on combating legalization of illegally gained income and terrorism.
- (o) The Republic of Kazakhstan also participated in the activity of a number of international organizations aimed at combating legalization of criminal income, corruption and terrorism (Eurasian Group on Combating Money Laundering and Terrorism Financing – EAG, EGMONT Group, International Organization of criminal Police “Interpol”).

19.23 Regarding the translation of the second part of the phrase: “*to determine its further operation in the interests of the country*” from the Order of President Nazarbayev dated 16 October 2008 (**Exhibit C-8**)

- (a) If one reads the Russian text, the second part of the phrase does not concern the companies (legal entities) at all. It concerns the permission which should be issued to a natural person whose name is not indicated for carrying out the activity in the interests of the country.
- (b) This part of the phrase is incorrectly translated into the English language. It has been translated as follows: “*to determine its further operations in the best interest of the country*” (**Exhibit C-8**)
- (c) In the Russian text (and the Russian text of the resolution is submitted as the original) there is neither the word *its*, nor the word *best*. The word «решать» is translated as to “*determine*”. This is one of the possible options of translation of the word *решать*,

however it is impossible in the present context (taking into account that there is no word its in the Russian text).

- (d) The literal translation of the second part of the letter is *“to permit his further activity in the interests of the country”*.
- (e) The word “its” «ero» (masculine gender) may in no way be attributed to the legal entity (in this case one should have used the word “eë” – the company (it is feminine gender in Russian). We assume that the second part of the resolution was obvious for the President of the Republic of Kazakhstan and for those to whom it referred not by virtue of the letter but rather by virtue of some other documents or oral conversations. The fact that it does not refer to the company is evident. As was noted earlier, the activity of the businessman A.Stati is characterized in the letter of the President of the Moldova extremely negatively. It is described as *“corrupt”, “blood business”, that “there is nothing Moldavan in his business but for the place of birth of the businessman itself”, etc.*
- (f) The Republic considered the second part of the phrase obviously refers to Mr. Anatolie Stati, since it was his unlawful activity which was the subject matter of the letter from the President of Moldova.
- (g) At the same time the ground for such instruction of the President of the Republic of Kazakhstan is also the requirement of the rule in Article 3 of the Treaty (**Exhibit R-106**).
- (h) Further, Article 14 of the Treaty sets forth that the *“High Contracting Parties shall expand and deepen their cooperation in combating criminality, terrorism, drug addiction as well as illegal drug trafficking, weapons and smuggling”*. (**Exhibit R-106**).
- (i) Taking into account the fact that the letter of the President of the Republic of Moldova contains information to the effect that *“Anatolie Stati proceeded to formation in Moldova of a corrupt lobby and interferes into the personnel and external policy of Moldova”* (**Exhibit C-77**), the President of the Republic of Kazakhstan gave such instruction based on international obligations of the Republic of Kazakhstan and its national interests.
- (j) According to Article 40 of the Constitution of the Republic of Kazakhstan, the President of the Republic of Kazakhstan is the head of the state, its senior official determining principal directions of domestic and foreign policy of the state and representing Kazakhstan inside the country and in international relations (**Exhibit R-91**).
- (k) At the same time we would like to emphasize that the word *“decide”* does not mean at all *“to prohibit”, “to bring to an end”*. Here the word *“to decide”* may be interpreted in the broadest sense, so as to include the words *“to check”, “to examine”*, since the letter about the illegal activity of Anatolie Stati was received from the first person of the state.

- (l) In other words the visa cited by the Claimants may be interpreted as “*to consider further work of Anatolie Stati in the interests of the country*”.
- (m) So, the translation appears to have been distorted which is significant as this is a document which is of primary importance for the case.
- (n) Moreover, it should be noted that based upon the results of the inspections and preliminary investigation by the Financial Police bodies Anatolie Stati was not held liable under the legislation of the Republic.
- (o) The Claimant’s assertion related to expropriation of its investments in Kazakhstan is false and does not correspond to reality, just like the indication at the initiative of the President of the Republic in this issue.

19.24 Regarding the further context provided by the President’s further instruction of 23 November 2009:

- (a) Following receipt of a letter from the governor of Mangystau region (**Exhibit C-293**) (discussed further below), on 23 November 2009 the President issued a further instruction (**Exhibit C-23**) in which he expresses concern that the investigations of companies including KPM and TNG might be interfering with the operation of those companies, creating problems for the local workforce. He goes on to state:

“Why is it necessary to stop the production?”

...

Checks should not lead to problems with people who are working”.

- (b) This completely contradicts the Claimants’ assertion that the President intended the checks to interfere with the operation of their businesses to force the Claimants to abandon their investments. In fact the President was expressly concerned to keep the businesses running, since his interests ultimately lay in benefiting the local Kazakh people obtained from being employed by KPM and TNG.
- (c) The reality of course is that the Claimants’ decision to wind down their companies had nothing to do with the Republic. Whilst the Claimants complain in a general sense that the need to respond to audits and investigations was an administrative burden, it would not cause either KPM or TNG to wind down their businesses and there is no evidence that it had such an effect.
- (d) The only concrete effects on the businesses of KPM and TNG which the Claimants identify are the removal of the General Manager of KPM, the cessation of construction of

the LPG plant and the enforcement activity relating to unpaid taxes and KPM's fine for carrying out illegal entrepreneurship.

- (e) As discussed at paragraph 27 below, the arrest, trial, conviction and imprisonment in September 2009 of Mr Cornegruta, the General Manager of KPM, was entirely lawful. However, even if it had not been, the Claimants do not describe, let alone evidence, any tangible effect that this had on the business of KPM. In any event, considering that KPM and TNG shared an office and its senior management worked closely together (Condorachi paragraph 2) there were several other senior managers on hand to cover for his absence including the Claimants' witnesses Mr Condorachi, Mr Pisica, Mr Lungu and Mr Stejar. Accordingly it is denied if alleged that the absence of Mr Cornegruta caused the effects on KPM's business to which the governor of Mangystau region referred in his letter of 26 August 2009. This could only result of the Claimants voluntarily winding down their operations.
- (f) Construction of the LPG plant was halted in May 2009 due to "*cash constraints*" (FTI page 54). However, none of the actions of which the Claimants complain and which might have caused this condition, had occurred by that point in time:
 - (i) The first court judgments in respect of corporate back taxes (which neither KPM nor TNG paid) were not delivered until 8 and 9 September 2009 (SoC 159 footnote 314). Naturally none of the related enforcement activity occurred until after that time.
 - (ii) Although KPM paid customs duties on oil exports in around July 2008 (SoC 163) the LPG plant was being built by TNG (FTI page 54), which paid no customs duties.
 - (iii) Transfer price taxes were not demanded until 29 December 2009 (SoC 174 footnote 337).
 - (iv) The fine on KPM in respect of illegal entrepreneurial activity was not imposed until 18 September 2009 (**Exhibit C-117**) and no enforcement action was taken until 29 December 2009 (SoC 123). In any event the LPG plant was being constructed by TNG. Naturally none of the related enforcement activity occurred until after that time.
 - (v) The enforcement action concerning unpaid taxes was lawful as discussed at paragraph 30 below. However, even if it had not been as noted above this occurred after 9 September 2009 and therefore cannot have had any effect on KPM; and TNG's businesses referred to in the letter of the Governor of Mangystau region dated 26 August 2009 (**Exhibit C-293**).
 - (vi) Enforcement action in respect of the fine imposed on KPM was lawful as discussed at paragraph 29 below. However even if the enforcement had not been lawful, it did not occur until 29 December 2009. Accordingly it cannot have been responsible for

the effects on KPM and TNG's businesses referred to in the letter of the Governor of Mangystau region dated 26 August 2009

- (g) In conclusion it is clear on analysis that none of the concrete effects on the businesses of KPM and TNG of which the Claimants say resulted from the Republic's activities could have caused the deterioration of the businesses of KPM and TNG, noted by the Governor of Mangystau region in his letter of 26 August 2009 and referred to in the President's instruction of 19 November 2009. These problems can only have occurred as a result of the Claimants' own decision to wind down the businesses of KPM and TNG.

19.25 In relation to the letter of the Governor of the Mangystau region dated 26 August 2009:

- (a) The Claimants say that in this letter the Governor:

"asked Prime Minister Massimov to accelerate the State's cancellation of TNG's and KPM's Subsoil Use Contracts and, implicitly, to transfer TNG's assets to KazAzot" (SoC 61).

- (b) Without any apparent explanation or evidence, this allegation is linked by the Claimants to the demise of a proposed agreement with KazAzot relating to an Ammonia Carbomide project (addressed in more detail at paragraphs 15.3 to 15.8), that is the Claimants sole justification for their frankly unrealistic proposition that KPM and TNG would have been able to sell gas at export prices rather than the much lower domestic prices (FTI pages 40 to 42).
- (c) The letter in question is principally a complaint concerning the failure by the MEMR to provide the necessary information concerning its investigations in to the activities of KPM and TNG and calls for action in light of the deteriorating condition of TNG and KPM described as:

"continuation of deterioration of industrial and financial situation of [TNG] and [KPM] (according to forecast data, natural gas extraction January to August of the current year decreased 41%, oil extraction - by 19%).

detection of financial violations in enterprise in a form of failure to pay large scale taxes to the budget;" (Exhibit C-293).

- (d) In addition to these issues the instruction of the President dated 23 November 2009 referred to

"a stop of all trades (oil and gas extraction) and the construction of the Gas Refining Factory, compressor stations and gas gathering units. Nearly 3 thousand people are fired, that leads to the conditions for social tension" (Exhibit C-23).

- (e) In the circumstances, it is not surprising that the Governor of the affected region should be concerned at what he perceived as slow progress of an investigation into the companies concerned or even that he questioned whether drastic action was required to resolve the situation in the interests of the local people and economy. Far from evidence of a conspiracy, this is an expression of genuine concern for the situation on the ground and frustration in light of a perceived failure by the organs of the State to take action.
- (f) However from the paragraphs above, it is clear that contrary to the Claimants' suggestion, none of this deterioration in the businesses of KPM and TNG resulted from the actions of the Republic and can only have resulted from the Claimants' voluntary decision to wind down the businesses of KPM and TNG to the detriment of the local economy.

19.26 In relation to the letter from the MEMR to the Ministry of Industry and Trade dated 28 September 2009 (**Exhibit C-294**):

- (a) At SoC 233 the Claimants refer to the MEMR's letter as proof that despite warnings from the MEMR, the Republic:

"knowingly engaged in its illegal scheme to effect the final takeover of Claimants' investments"

and

"carried out its illegal scheme without regard for its legal obligations to Claimants and despite those clear warnings".

- (b) Quite aside from the fact that the Claimants' point presupposes the illegality of the Republic's actions, which is denied, the Claimants' portrayal of the letter is an exercise in selective quotation which completely misrepresents the context, purpose and conclusions of the letter.
- (c) As is apparent from the introduction to the letter, the MEMR is responding to the concern expressed in the letter of Governor of Mangystau Region at the decline of the businesses of TNG and KPM and the resultant social problems.
- (d) The solution under consideration is undoubtedly the transfer of KPM and TNG into state control. Considering the extent of the problems and that, as demonstrated by the above analysis, they appear to result from the decisions of the Claimants and the fact that such assets are considered by the Republic to be strategic assets, this is not surprising. Crucially is it in any way sinister or indicative of unlawful intentions to consider acquiring those assets?

- (e) This letter is no grand plan for the expropriation of the Claimants' assets. Equally it is not a warning to its recipients. The writer is not a lawyer and does not purport to conduct an exhaustive legal analysis of the Republic's rights and liabilities. Rather it is a pragmatic commercial assessment of the preferred approach to dealing with the social problems caused by the Claimants apparent decision to wind down the operations of KPM and TNG.
- (f) Having dismissed the option of gratuitous transfer and considered the risks then perceived to pertain to the termination of contracts at that time, the MEMR settles on its preferred course of action:

"In the nearest time, the Ministry together with KMG is planning to initiate negotiations with the owners of 'Tolkynneftegas' LLP and 'Kazpolmunai' LLP regarding further acquisition of their assets.

- (g) Further, this letter is a snapshot of the MEMR's view of the best way to deal with the decline of TNG and KPM as at the end of September 2009. It says nothing as to the view of the MEMR at a different time or in different circumstances.

19.27 In relation to the letter from the President of the Blagovest Fund to the MEMR dated 7 February 2010 (**Exhibit C-23**):

- (a) The Blagovest fund is one of the thousands of non-commercial organizations existing in the territory of Kazakhstan. According to the information of the Ministry of Justice of the Republic of Kazakhstan, at present 5772 non-governmental foundations are registered in the territory of the Republic of Kazakhstan (**Exhibit R-116**).
- (b) A social foundation is not a governmental organization. It acts in accordance with paragraph 1 Article 107 of the Civil Code of the Republic of Kazakhstan (**Exhibit R-8**) and paragraph 1 article 12 of the Law of the Republic of Kazakhstan "On Non-Commercial Organizations" (the Law) (**Exhibit R-117**). This is a non-membership, non-commercial organization created by individuals and (or) legal entities on the basis of voluntary contributions of assets and pursuing social, charitable, cultural, educational and other socially useful objectives. By virtue of paragraph 4 Article 12 of the Law as a social foundation shall be recognized a foundation established by natural persons which are not members of one family and (or) legal entities – public associations. The property of a social foundation shall be formed out of one-time and (or) regular contributions of legal entities – public associations and natural persons, as well as from other sources provided for by Article 35 of the Law and corresponding to the goals of activity of a social foundation.

- (c) “Blagovest” Foundation applied to the Minister of Energy and Mineral Resources of Kazakhstan with the offer to assist in solving problematic issues connected with KPM and TNG (**Exhibit C-23**). However the evidence of the head of the Foundation, Zakharov shows he had no clear idea of what he was offering in the application signed by him. He was approached by the former Director of the company “APM G.V. Andreev” who decided to earn money acting as a mediator between Kazakhstan and Stati in solving the existing situation. Zakharov signed the application prepared by Andreev who had promised to him to provide financing in consideration of this service.
- (d) According to oral information provided by Andreev, Zakharov understood that the property of Stati was transferred to the labour collective and it was exactly in this meaning that he used the word nationalization. As for the rest he was not familiar with the situation at all.
- (e) In view of the aforesaid the opinion of the Foundation in this case as a private opinion of a private person should not be considered by the Tribunal to represent the opinion or intentions of the Government of the Republic of Kazakhstan.

- 19.28 In conclusion, the Claimants attempt to enliven a story of the unremarkable exercise by state bodies of powers of audit and inspection and prosecution by re-casting it as a grand conspiracy fall flat.
- 19.29 Regardless of whether President Voronin’s letter was privately motivated by any tension between him and Anatolie Stati, what follows is an entirely proper concern on the part of President Nazarbayev to establish the truth in the interests of the Republic. His instruction contains no hyperbole, no malice and no grand plan. It is simply an instruction to investigate.
- 19.30 The letter from the Governor of the Mangystau region is a quite understandable response to an apparent perception that nothing was being done to address the social tension emanating from the decline of KPM and TNG. As can be seen from the analysis of events, that decline had nothing to do with the actions of the Republic.
- 19.31 The letter from the MEMR is a straight forward commercial assessment of the MEMR’s preferred way of dealing with the decline of KPM and TNG as at September 2009.
- 19.32 Of the five items of correspondence referred to above, only the Blagovest letter can be said to be at all remarkable. Unfortunately for the Claimants, it is remarkable only because it emanates from a former director of KPM.

20 The Republic's entitlement to conduct audits and inspections

- 20.1 The Claimants say that in the period 2008 to 2010 inclusive, the Republic conducted a campaign of harassment by way of a large number of intrusive audits and inspections, referring to inspections by a range of ministries and committees.
- 20.2 At SoC para 77 the Claimants describe the audits and inspections as “unprecedented”. They assert that the senior management of KPM and TNG spent most of its time answering to the inquiries of state bodies. As the former General Director of TNG and Representative of General Director of KPM Mr. Alexander Cojin declares: *“I have witnessed KPM and TNG transform from working, fully operative and functional oil and gas production companies to two bodies that exist to answer requests from various Government officials and write reports. This process began around November 2008 and continued for nearly two years.”*
- 20.3 The Republic's position is that, the Claimants have generally sought to over emphasise the scale of the audits and inspections carried out by the Republic, using emotive terms such as “audit blitz” (SoC paragraph 89) and making multiple references throughout the Statement of Claim to intensive audits when in reality they refer only to two groups of audits, one in October/November 2008 and another in June/June 2010.
- 20.4 The degree of hyperbole that the Claimants are driven to in an attempt to portray audits and inspections as being part of an oppressive master plan use speaks volumes as to the true unremarkable character of the activities.
- 20.5 Furthermore no evidence is provided that many of the alleged inspections actually took place, for example audits by:
- (i) the Customs committee complained of at SoC paragraph 11, 76 and 161;
 - (ii) the Ecology Committed complained of at SoC paragraph 76; and
 - (iii) the Ministry of Emergency Situations complained of at SoC paragraph 76.
- 20.6 Furthermore, no evidence is provided that the audits and inspections themselves caused real disruption or economic harm to KPM and TNG as opposed to being a nuisance to the personnel of KPM and TNG. Accordingly the Claimants have failed to adequately demonstrate if (and if so, how) the Republic's inspections and awaits of KPM's and TNG's compliance with the contracts adversely affected their alleged investments.
- 20.7 Rather the Claimants' true complaint, for which there can be no proper justification, appears to be that the audits and inspections revealed substantial failures to comply with tax and licensing legislation and TNG's and KPM's Subsoil Contracts which led, ultimately, to the imposition of back taxes, fines and ultimately to the termination of those contracts.

- 20.8 As set out in paragraphs 20.10 to 20.33 below:
- (a) the Republic was fully entitled to carry out frequent and detailed inspections of KPM and TNG; and
 - (b) KPM and TNG were not subject to any greater scrutiny by way of audits and inspections than other similar companies.

20.9 Accordingly, it is the Republic's position that the Claimants' case concerning audits and inspections amounts to little more than a complaint that the Republic was exercising its contractual rights in furtherance of its obligation to the people of Kazakhstan.

The Republic's contractual rights to receive information and to conduct audits and inspections

20.10 Based on Article 1 (6) (f) of the ECT, investment means any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector (**Exhibit C-1**).

20.11 As noted in paragraph 4 above, the Republic's fundamental interest in permitting companies such as KPM and TNG to exploit the natural resources of Kazakhstan is to ensure benefits flow to the people of Kazakhstan. KPM and TNG were granted considerable autonomy to explore and exploit the territories covered by their Subsoil Contracts and Subsoil Licences. In order to ensure that these territories were exploited in a manner which was lawful and ultimately of benefit to the people of Kazakhstan, the Subsoil Licences and Subsoil Contracts effectively provided for an "open book" regime under which KPM and TNG were obliged to provide a considerable quantity of information to the agencies of the Republic, which were entitled to carry out wide ranging inspections to verify the accuracy of the information and that KPM and TNG were performing the terms of the respective contracts. The contractual rights to obtain information were backed up by similar powers granted by the legislation of the Republic.

20.12 KPM and TNG carried out their activities on the basis of licenses and contracts for subsoil use (Contract № 305, Licence MG 309-D in effect since 23 May 1997; Contract № 210, License MG №242-D, in effect since 4 December 1997; Contract №302, License MG №243-D in effect since 4 December 1997). The license has priority and the contract cannot contradict it (see paragraph 32.5 of Contract № 305, as well as paragraph 27.5 of Contracts № 302 and № 210).

20.13 The relevant provisions of KPM and TNG's Subsoil Contracts and Subsoil Licences are as follows:

- (a) Item 11 of KPM's Subsoil Licence dated 23 May 1997 (**Exhibit C-45**) and TNG's Subsoil Licences each dated 4 December 1997 (**Exhibit C-52 and C-53**) provides:

“Control Procedures. The use of the subsurface shall be controlled by state regulatory agencies pursuant to the Laws of the Republic of Kazakhstan”

- (b) KPM's Subsoil Contract number 310 dated 30 March 1999 (**Exhibit C-45**) provides:

7.2 The Contractor is obliged to:“

7.2.12 To make all necessary documents and information freely available to the control bodies of the State as well as provide them with access to work sites while they are on official duty, and eliminate any violations established by these bodies in time.”

“7.4 The Competent Body has the right to:

7.4.4 Inspect performance by the Contractor of Exploration and Production as well as examine documentation of the Contractor relating to activities aimed at performing the Contract.

7.4.5 Access any work on the contract Area relating to Exploration and Production”

“12.1 The Contractor commits to keep records and maintain documentation relating to carrying out Exploration and Production under the Contract within the stipulated time and in accordance with the legislation of the State.

...

12.4 The Competent Body has the right to monitor compliance by the Contractor with the provisions of the Contract and may be present via his representatives at the performance by the Contractor of Exploration and Production.”

“17.12 Access to Information. The Contractor hereby agrees that tax authorities of the Republic may have access to the information relating to any banking accounts of the Contractor including those opened with foreign banks outside the Republic. The Contractor agrees to provide the tax authorities of the Republic with any information relating to such accounts which may be requested from time to time and in respect to such accounts waives hereto any confidentiality tights that may exist due to provisions of the legislation concerning the banking secret and other similar Laws”

“18 Book Keeping

18.1 The Contractor obliges to keep a complete and accurate record of all revenues and expenditures connected with the performance of the Contract in accordance with the record keeping procedures set by the legislation of the State.

18.2 All books and registration documents of the Contractor are accessible for inspection by the Competent Body and other State Bodies within their respective jurisdiction as stated by the legislation of the State.”.

- (c) Supplement number 3 to KPM’s Subsoil Contract dated 9 February 2004 (**Exhibit C-45**) provides:

“17.13 Access to information

17.13.1 Contractor recognises that, in accordance with the applicable law, tax authorities of the Republic of Kazakhstan shall have access to information regarding any bank accounts of the Contractor, including those established with foreign banks outside the Republic.

7.13.2 The Contractor, according to the procedure established by the Legislation, shall present to the personnel of the respective state authorities upon conduct of audits within their competences, all the necessary and requested information that refers to the activity performed under the Contract”.

- (d) TNG’s Subsoil Contract number 210 dated 30 March 1999 (**Exhibit C-52**) provides:

“6.2 The Contractor is obliged to:

6.2.15 Freely present the necessary documents, information and access to work places to control bodies of the Republic during the discharge of their duties and in proper time eliminate revealed by them infringements”

“6.4 The Competent Body has the right to:

6.4.4 Inspect the performance of the Contractor of Exploration and Production, as well as to examine documentation of the Contractor relating to the activities under execution of the Contract.

6.4.5 Access to any works in the contract Area relating to Exploration and/or Production testing”

“9.1 The Contractor undertakes to keep records and maintain documentation relating to conducting Exploration and Production under the Contract within the stipulated period and in accordance with the legislation of the State.

...

9.3 Under mutual agreement of the Parties, the Competent Body shall have the right to inspect the compliance of the Contractor’s activities within the provisions of

the Contract and may be represented via its representatives during the conducting of works by the Contractor.”

“12.12 Access to Information. The Contractor hereby agrees that tax authorities of the Republic may have access to the information relating to the accomplishment by the Contractor of its obligations under this Contract, including information, which is a bank secret, and related to any of the bank accounts of the Contractor, including those opened in foreign banks outside the Republic.”

“13 Book Keeping

13.1 The Contractor obliges to keep a complete and accurate record of all revenues and expenditures connected with the performance of the Contract in accordance with the record keeping procedure set by the State legislation.

13.2 All account books and accounting documents of the Contractor are to be kept properly and shall be accessible for audit carried out by the Competent Body, Tax authority and other State bodies within their respective jurisdictions as stated by the legislation of the State.”.

- (e) Supplement number 5 to TNG’s Subsoil Contract 210, dated 28 January 2004 (**Exhibit C-52**) provides:

“12.13 Access to information

12.13.1 Contractor recognises that, in accordance with the applicable law, tax authorities of the Republic of Kazakhstan shall have access to information regarding any bank accounts of the Contractor, including those established with foreign banks outside the Republic.

12.13.2 The Contractor, according the procedure established by the Legislation, shall present to the personnel of the respective state authorities upon conduct of audits within their competencies, all the necessary and requested information that refers to the activity performed under the Contract.”.

- (f) TNG’s Subsoil Contract 302 dated 31 August 2008 (**Exhibit C-53**) provides:

“6.2 The Contractor is obliged to:

6.2.15 Present the necessary documents, information and allow full access to work places to the regulatory bodies of the Republic upon discharge of their duties and remedy the detected violations in due time.”

“6.4 The Competent Body has the right to:

6.4.4 *Inspect in the course of Exploration and/or Production Testing Operations including inspection of the Contractor's documentation concerning fulfilment of the Contract terms.*

6.4.5 *Access to any works related to Exploration and/or Production Testing within the Contract Area."*

9.1 *The Contractor undertakes to maintain records and keep within the given period all the account documentation relating to the Exploration and Production Testing hereunder and in accordance with the legislation of the Republic.*

...

9.3 *The Competent Body shall have the right to verify fulfilment of the Contractor's contractual terms and through its representatives can attend at the Exploration and Production Testing Operations."*

"12.12 Information access. The Contractor recognizes that that (sic) tax authorities of the Republic shall have access to information relating to accomplishment by the Contractor of its obligations hereunder, including information which is banking secret and relate to any bank accounts of the Contractor including the ones established with foreign banks outside the Republic."

"13.1 The Contractor shall provide full and accurate book-keeping of all profits and inputs in connection with the Contract fulfilment in compliance with book-keeping procedures established by the legislation of the Republic.

13.2 All account books and accounting documents of the Contractor shall be kept properly and shall be accessible for audit carried out by the Competent Body, Tax authorities and other public agencies within their respective jurisdictions specified by the legislation of the Republic."

- (g) Supplement number 4 to TNG's Subsoil Contract, dated 4 July 2003 provides:

"23.13 Access to information

12.13.1 Contractor recognizes that, in accordance with the applicable law, tax authorities o the Republic of Kazakhstan shall have access to information regarding any bank accounts of the Contractor, including those established with foreign banks outside the Republic.

12.13.2 The Contractor, according to the procedure established by the Legislation, shall present to the personnel of the respective state authorities upon conduct of

audits within their competences. All the necessary and requested information that refers to the activity performed under the Contract.

20.14 The Claimants do not explain how any of the audits and inspections referred to are outside the above contractual rights to receive and acquire information from KPM and TNG. Accordingly the Claimants have failed to demonstrate that the Republic did anything other than enforce its contractual rights against those companies. Further, despite the Claimants' florid language they fail to prove that these actions were part of a conspiracy.

The Republic's legislative rights to undertake audits and inspections

20.15 The Code of Administrative Offences of the Republic of Kazakhstan in force since 2001 covers over 450 offences. The right to carry out inspections and the right to bring to responsibility is vested with 55 state bodies. Besides, the right to bring to responsibility upon the results of inspections was granted also to the courts (**Exhibit R-118**).

20.16 The "*Code of Administrative Violations of the Republic of Kazakhstan*" 2001 covers over 450 Offences. The right to carry out inspections and the right to bring to prosecute infringements is vested in 55 state authorities, in addition to any such rights that are granted by the courts. (**Exhibit R-118**)

20.17 Under Article 17 of the "*Law on Subsoil*" 2010 (**Exhibit R-152**) subsoil users such as KPM and TNG are subject to constant monitoring by the Ministry of Oil and Gas. In particular, Article 17 calls for monitoring of:

- (a) performance of contractual obligations;
- (b) purchasing of the required proportion of Kazakh goods;
- (c) purchasing of the required proportion of Kazakh works and services; and
- (d) employment of the required proportion of Kazakh members of staff.

20.18 Paragraph 6 of the "*The rules of monitoring and enforcement of the conditions of subsoil use contracts*" 2007 (**Monitoring and Enforcement Rules**) provides guidance on how the Republic was to monitor KPM and TNG's compliance with their obligations under their Subsoil Contracts:

"Monitoring of compliance with the conditions of contracts shall be based on primary data provided by mining companies in the form of statements, written explanations on the implementation of contracts and legal requirements in conducting mining operations, as well as data of public bodies involved in monitoring in accordance with the Law on Subsoil and (or) authorized in accordance with the laws to state control over compliance with requirements of subsoil users to legislation of the Republic of Kazakhstan to conduct subsoil operations. " (**Exhibit R-156**)

20.19 Further, paragraph 13 of the Monitoring and Enforcement Rules provides:

"all monitoring data, including requests from other government agencies, the competent authority enters into a single database of information - a unified national system for monitoring subsoil of Kazakhstan." **(Exhibit R-156)**

20.20 Paragraph 17 of the Monitoring and Enforcement Rules provides:

"If monitoring identifies non-compliance by a user of mineral resources with the term and conditions of a contract, the competent authority takes measures against such user of mineral resources pursuant to the laws and provisions of the contract." **(Exhibit R-156)**

20.21 Turning to the legislative provisions relevant to the particular audits and inspections complained of, where the Claimants exhibit the various notices and requests and reports issued by the Republic's inspection bodies, the legal basis for the audit is cited therein. Examples include:

- (a) The first page of the reports of the Tax Committee into the audits of KPM and TNG referred to at SoC 156, which the Claimants complain lead to the imposition of corporate back taxes, confirm that the audit was carried out:

"in compliance with the Code of The Republic of Kazakhstan of June 12 2001 "On taxes and other mandatory payments to the budget". **(Exhibit C-155)**

- (b) The third page of the reports by the Geology Committee into the inspections of KPM and TNG's production and exploration activities complained of at SoC paragraph 76:

"According to posts 1 and 11 articles 8-1, article 5-1 of Law of the Republic of Kazakhstan "About subsoil and subsoil use", Article 37 of the Law of the Republic of Kazakhstan "About Oil" and on the basis of the instruction on the check..." **(Exhibit C-86 and C-87)**

- (c) The letter of the National Bank of Kazakhstan to the Agency for Fighting Economic and Corruption Crimes **(Exhibit C-15)**, concerning the inspection complained of at SoC paragraph 76:

"So, according to article 63-3, point 1 from the Law regarding the National Bank of the Republic of Kazakhstan, the National Bank is entitled to render an exceptional inspection" **(Exhibit C-15)**

- (d) The notice of the inspection of the Ministry of Environment and Ecology to KPM and TNG complained of at SoC paragraph 200:

"Governed by i.7 of art 37-1 of the Law of the Republic of Kazakhstan of January 21, 2006 No. 124 "On Private Entrepreneurship", Mangystau Oblast branch of the

Zhaik-Caspian Department of Ecology shall conduct unscheduled inspection”
(Exhibit C-182)

20.22 The Claimants appear not to explain how any of the audits and inspections referred to are outside the powers of the Republic and its various investigative bodies to receive and acquire information from KPM and TNG. Accordingly the Claimants have failed to demonstrate that the Republic did anything other than enforce its rights against those companies under Kazakh law. Again the Claimants fail to demonstrate any element of conspiracy in the Republic’s actions.

KPM and TNG were not audited/inspected more than other companies

20.23 The Claimants complain that the staff of KPM and TNG were entirely absorbed responding to audits and inspections of which they complain.

20.24 It is not disputed that complying with audits and inspections takes time and doubtless the staff of KPM and TNG did not relish this task. However, given the extensive contractual and legislative inspection rights referred to in paragraphs 20.10 to 20.22 above, of which the KPM and TNG and the Claimants were or ought to have been aware, the Claimants ought to have made provision for such events by, for instance, engaging sufficient manpower to meet their contractual and legal obligations to provide information in the course of audits and inspections whilst at the same time continuing to run their business.

20.25 It is hardly reasonable to blame the Republic for the Claimants’ failure adequately to resource KPM and TNG.

20.26 Further, KPM and TNG were not subject to more audits or inspections than other similar companies.

20.27 According to the legislation of the Republic of Kazakhstan in effect in the period from 2001 till 2010¹²³, each inspection ordered is registered on a mandatory basis with the General Prosecutor’s Office, which carries out a statistical activity in the sphere of legal statistics and

¹²³ Order of the Prosecutor General of the Republic of Kazakhstan of 29 December 2000 № 66 “On Approval of the Rules “On the Procedure of submission and registration of documents of primary accounting of all inspections of the activity of economic entities” and cancellation of the Order of the Prosecutor General of the Republic of Kazakhstan № 83 of 29 September 1999” **(Exhibit R-119)**

Order of the Prosecutor General of the Republic of Kazakhstan of 25 April 2002 № 27 “On Approval of the Rules “On the Procedure of submission and registration of documents of primary accounting of all inspections of the activity of economic entities” and cancellation of the Order of the Prosecutor General of the Republic of Kazakhstan № 66 of 29 December 2000” **(Exhibit R-120)**

Order of the Prosecutor General of the Republic of Kazakhstan of 1 March 2004 № 1 “On Approval of the Guideline to accounting of inspections of the activity of economic entities” **(Exhibit R-121)**,

Order of the Prosecutor General of the Republic of Kazakhstan of 14 November 2007 № 4 “On Approval of the Guideline to state registration, statistical accounting and control over inspections conducted by state bodies of the Republic of Kazakhstan” **(Exhibit R-122)**,

Order of the Prosecutor General of the Republic of Kazakhstan of 24 December 2009 № 71 “On Approval of the Guideline to uniform state registration, accounting and control over inspections conducted by state bodies of the Republic of Kazakhstan” **(Exhibit R-123)**,

The Law of the Republic of Kazakhstan “On Protection and Support of Private Entrepreneurship” **(Exhibit R-124)**,

special accounting, in accordance with subparagraph 12 Article 4 of the Law of the Republic of Kazakhstan "On Prosecutor's Office" (**Exhibit R-126**).

20.28 **Exhibit R-118** contains the analysis of inspections carried out by state bodies including TNG and KPM, prepared by the General Prosecutor's Office of the Republic of Kazakhstan.

20.29 This demonstrates that far from being audited more frequently than other companies, as the Claimants suggest, KPM and TNG were in fact audited less or to a similar degree than other companies. For instance by reference to the statistics for subsoil users in Mangystau Province, such as KPM and TNG for there period 2001 to 2010, in that period KPM and TNG were the second and third least audited companies as follows:

- (a) KPM was audited 88 times;
- (b) TNG was audited 100 times;
- (c) Karazhanbasmunai was audited 246 times;
- (d) Mangistaymunaigaz was audited 298 times;
- (e) Uzenmunaigaz was audited 390 times; and
- (f) Emir Oil was audited 76 times.

20.30 Looking more closely, in 2008 when the Claimants complain of an "*inspection blitz*" (Soc 76) KPM and TNG were again the first and third least audited subsoil users in Mangystau Province as follows:

- (a) KPM was audited 6 times;
- (b) TNG was audited 11 times;
- (c) Karazhanbasmunai 13 times;
- (d) Mangistaymunaigaz was audited 24 times;
- (e) Uzenmunaigaz was audited 77 times; and
- (f) Emir Oil was audited 9 times.

20.31 Of the above companies, it is notable that Uzenmunaigaz, the company subject to the greatest number of audits between 2001 and 2010, is state owned.

20.32 Further despite the transfer of the Claimants assets into trust management under a national company - "Offshore Oil Company MazMunaiTenyz" JSC - they have been subject to three audits by state bodies as at the end of August 2011.

20.33 Clearly therefore the Claimants' sense of bias was no more than a subjective perception, seemingly brought about by a failure to appreciate and provide sufficient resource to deal with the degree of scrutiny the Republic would legitimately exercise.

Conclusion

20.34 The various inspections and audits of KPM and TNG carried out by agencies of the Republic were lawful. Further, despite the Claimants florid language and invitation to conclude that these acts were part of a conspiracy, KPM and TNG were subjected to, if anything, fewer audits and inspection than other comparable companies.

20.35 Accordingly all allegations of wrongdoing in connection with the carrying out of the audits and inspections described above are denied.

21 Concerning trunk pipelines

The Claimants' position

21.1 Description of the situation connected with trunk pipelines in the Statement of Claim (paragraphs 99-106)

(a) Concerning the issue of trunk pipelines the Claimants present the facts without any logic. It does not deny that in the Republic of Kazakhstan existed the obligation for licensing of the operation of trunk pipelines (paragraph 80 of the Statement of Claim).

(b) At the same time it asserts:

(i) first, that it had the license for operation of pipelines (on this assertion almost all expert opinions are based – see in more detail subparagraph2) paragraph. 8.3.2. of the Statement of Defence, and

(ii) second, the pipelines it operated were not trunk pipelines.

(c) In support of the second assertion it adduces solely technical arguments (see, for instance, paragraphs 85 and 86 of the Statement of Claim).

(d) At the same time the Claimants state that for determination of whether the pipeline is a trunk pipeline the technical side is of no importance (see the Opinion of academician M.K. Suleymenov, **Exhibit C-108**).

- (e) The Claimant does not deny either that it had applied for the license to operate trunk pipelines but failed to obtain it. The fact of the Claimant's application for the license renders its arguments in respect of the absence of the necessity of receipt of such license **strange and unconvincing**.
- (f) It is misleading of the Claimants to say that KPM's pipeline allegedly was "reclassified" by the Republic of Kazakhstan from a filed pipeline into the trunk pipeline (see, for instance, paragraph 87 of the Statement of Claim) and that these actions were unlawful. In fact there was no re-classification of the pipelines. Simply in the course of the inspection the Republic of Kazakhstan found that the Claimants had no license for operation of the pipelines which were considered trunk pipelines under the legislation of the Republic of Kazakhstan. As a result the Claimants was held liable for illegal entrepreneurship (carrying out of the licensed activity without a licence).

21.2 On what the Claimants' position is based?

- (a) According to G.V. Andreev, "in violation of the legislation of the Republic of Kazakhstan on oil and contracts without amending them Stati has combined the production and technological processes of all companies, having in fact created a new subsoil user with a permanent body in the city of Kishinev (illegal entrepreneurial activity)" – (**Exhibit R-34.1**).
- (b) From this viewpoint testimonial evidence is of interest. The witness statement of Kozhin (paragraph 3): "our infield pipelines". The witness statement of Romanosov: "our pipelines for internal use" (paragraph 13), "three of our four infield pipelines of internal use" (paragraph 21).
- (c) Even in its Statement of Claim the Claimants does not realize that in terms of the legislation of the Republic of Kazakhstan "Kazpolmunay" LLP and "Tolkynneftegaz" LLP are independent legal entities each of which has its own contractual territory. Even the mere fact that "Kazpolmunay" LLP rendered services to "Tolkynneftegaz" LLP for oil transport by its pipeline is indicative of the fact that this pipeline is not the field pipeline (since the field pipeline may in no circumstances be used for rendering the services for oil transport to third organizations).

21.3 Requirement of the legislation of the Republic of Kazakhstan in respect of licensing of trunk pipelines

- (a) The Claimants do not express any doubts to the effect that the activity type "trunk pipeline operation" is subject to licensing in the Republic of Kazakhstan.
- (b) As academician M.K. Suleymenov correctly notes in his opinion (**Exhibit C-108**, p.6) such type of activity as oil transport by trunk pipelines is provided for in Article 4 of the

Law of the Republic of Kazakhstan of 9 July 1998 № 272 “On Natural Monopolies” (**Exhibit R-127**). A legal entity operating such pipeline is considered as the subject of natural monopoly and falls under special licensing. At present such licensing is provided for by Article 12 of the Law of the Republic of Kazakhstan “On Licensing” № 214 of 11 January 2007 (**Exhibit R-24 and R-139**)¹²⁴. The functions of licensing of operation of gas trunk pipelines, oil pipelines, oil-product pipelines were transferred in accordance with the Decree of the President of the Republic of Kazakhstan of 19 June 2007 № 346 “On Further Improvement of the System of State Management of the Republic of Kazakhstan” to the Agency of the Republic of Kazakhstan for Regulation of Natural Monopolies (**Exhibit R-128**) to which the Claimants applied for re-issuance of the license, but did not obtain it.

- (c) The Claimants do not deny that it had no license for operation of trunk pipelines.

Criticism of the Claimants’ arguments

21.4 Criticism of technical documentation

- (a) In its Statement of Claim the Claimants are trying to prove by way of comparison, with the use of schemes, that from the technical standpoint the pipelines operated by “Tolkynneftegaz” LLP and “Kazpolmunay” LLP are not trunk pipeline (paragraphs 85, 86 of the Statement of Claim). It has also submitted the opinion of the scientific, research and design institute of oil and gas (**Exhibit C-101, C-102**).
- (b) At the same time expert examination of the Ministry of Justice of the Republic of Kazakhstan ordered by the court confirmed that by its technical characteristics the pipeline is a trunk pipeline.
- (c) Thus, for example, with reference to SNiP (Construction norms and specifications) 2.05.06.-85 the expert of the Ministry of Justice of Kazakhstan found that the pipeline by its diameter is a trunk pipeline of the 4th class and by its working pressure – a trunk pipeline of the 1st class (**Exhibit C-110.2, p.5**).
- (d) In response to expert examination the All-Russian Scientific and Research Institute for Construction and Operation of Pipelines prepared Consultation № 35 (**Exhibit C-107**). The experts agree (p.3) that technical characteristics of field and trunk pipelines may overlap due to harmonization of the normative documents in force in the sphere of pipeline design.

¹²⁴ Earlier (prior to entry into force of the 2007 Licensing Law) the named type of activity was subject to licensing in accordance with the Law of the Republic of Kazakhstan of 17 April 1995 № 2200 “On Licensing” (**Exhibit R-24**).

- (e) In the opinion of the academician M.K. Suleymenov cited by the Claimant (**Exhibit C-108, p. 5**) the following is said:

“from the technical point of view, there is no difference between pipelines, including oil main pipelines and non-main oil pipelines, since both are pipelines designated for the transportation of oil. The safety requirements for the operation of oil main lines and non-main ones, foreseen in separate CNaS, regulations, etc. for oil-main pipelines and non-main ones, could coincide as these requirements are determined by the technical specifications that can be the same (physical-chemical parameters, pipe diameter, acceptable pressure, needed engineering facilities, other technical decisions for the assurance of safe operation, and so on).”

- (f) In our opinion, the arguments of the Claimants are self-contradictory and do not stand up to criticism. On the one hand, the Claimants prove that by its technical characteristics the pipelines operated by it could not be referred to the category of trunk pipelines. On the other hand, the Claimant agrees that it is impossible to draw the line between field and trunk pipelines **by technical characteristics**.
- (g) Thus, the Claimant's conclusion that in technical terms the concerned pipelines are not referred to trunk pipelines does not stand up to any criticism. The Claimant agrees that from the technical standpoint it is impossible to draw a clear delineation between the trunk and field pipelines.

21.5 Criticism of legal documentation

The Claimants state that it had the license for operation of the pipelines

- (a) The Claimant asserts that “Kazpolmunay” LLP had License № 004178 dated 5 August 2005 for the activity type “operation of industrial fire and explosion dangerous and mining productions, underground facilities, as well as boilers, tanks and **high-pressure pipelines**, oil and gas drilling operations” issued by the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan (**Exhibit C-83**). TOO “Tolkynneftegaz” had License № 004175 of 5 August 2005 for the activity type “operation of industrial fire and explosion dangerous and mining productions, underground facilities, as well as boilers, tanks and **high-pressure pipelines**, oil and gas drilling operations” issued by the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan (**Exhibit C-84**).
- (b) At the same time the enclosures to the licenses of “Kazpolmunay” LLP № 004178 of 5 August 2005 and “Tolkynneftegaz” LLP № 004175 of 5 August 2005 specify in respect

of the pipelines that **steam and hot water pipelines** operating under pressure are concerned (and not the operation of gas pipelines, oil pipelines, oil product pipelines). So that these references to licenses as related to “high-pressure pipelines” are legally incorrect. This is confirmed by **Exhibit C-85** (third paragraph) which contains the opinion of the Head of Department of the Financial Police as well as by **Exhibit C-88** (the last paragraph) which contains the opinion the Deputy Chairman of the Agency of the Republic of Kazakhstan for Regulation of Natural Monopolies.

The Claimants proceed from that that it had the license for hydrocarbon production which included the right to oil transport up to the trunk pipeline

- (c) The Claimants assert that “Kazpolmunay” LLP possesses the state License № 002093 dated 29 May 2008 for the activity type “Operation of mining productions” in the enclosure to which such type of activity is included as “**oil, gas and gas condensate production**” (information from **Exhibit C-96**).
- (d) Further the Claimants refer to Article 1 of the Law of the Republic of Kazakhstan “On Oil” dated 28 June 1995 № 2350. This article defines **production** as any operations related to oil recovery, **which include in particular construction and operation of ground-surface and underground industrial equipment and structures (including the pipeline) “for oil transport from the place of recovery to the place of transshipment to a trunk pipeline and (or) another means of transport” (Exhibit R-23).**
- (e) Legal reasoning of the Claimants is based exactly on this assertion.
- (f) In support of its position the Claimants cite the letters of the Ministry of Emergency Situations of the Republic of Kazakhstan (**Exhibit C-90, C-91**)¹²⁵, the letters (opinion) of the Kazakh Institute of Oil and Gas (**Exhibit C-99, C-100**), of the Scientific and Research Centre of the Ministry of Emergency Situations of Kazakhstan (**Exhibit C-104**), the All-Russian NII for construction and operation of pipelines (**Exhibits C-105, C-106 and C-107**)¹²⁶ and academician M.K. Suleymenov (**Exhibit C-108**).

¹²⁵ As is correctly noted in **Exhibit C-92** the issuance of such kinds of opinions falls beyond the scope of the Ministry of Emergency Situations, so the question arises as to how such opinions were obtained?

¹²⁶As far as the opinions of the All-Russian NII for construction and operation of pipelines (**Exhibits C-105, C-106 and C-107**) are concerned: it is surprising that Russian experts (Varshitzkiy, Rozhdestvenskiy, Khankin - **Exhibits C-105 and C-106**) use in a free manner the Kazakh oil legislation (paragraph. 8.2 of the opinions). The question then arises whether they have respective education and whether they are entitled to submit their opinions in this field.

It is also surprising that the mentioned NII acts in two persons. The opinions are drawn up on the letterheads of the open joint-stock company, whereas the signatures of the employees of a limited liability company are affixed. And on the first page is the stamp of a joint-stock company and the signature of its President under the word “Approved”. This joint-stock company sets

- (g) All the above mentioned experts come to conclusion that the Claimants had the license for oil production and hence for oil transport.
- (h) Conclusions of the Claimants and its experts in this field do not correspond the reality.
- (i) The Contractors did not proceed with oil production, they were at the stage of pilot works which according to the definition in the Oil Decree refer to exploration. However even if the stage of oil production have been already entered upon in case of combined exploration and production it should be taken into account that as of the date of conclusion of the contracts operation of pipelines is not mentioned in the definition of the term "production." Such wording appeared only after introduction of amendments and addenda to the Oil Decree by the Law of the Republic of Kazakhstan of 1 December 2004 № 2-III (**Exhibit R-129**).
- (j) The contracts contain a definition of the term "production" which does not include transportation (see, for instance, paragraph. 1.9 of Contract № 210).
- (k) **Along with the above mentioned its should be taken into account** that oil production was carried out by the Claimants on the basis of Contracts № 210 and № 305 (concluded on the basis of Licenses MG № 242-D and MG №309-D)¹²⁷ within **the contractual area defined inn each of these contracts and licenses B** (see paragraph 4.1 of Contract № 305 and paragraphs 4.1 and 6.1.1 of Contract № 210).
- (l) Hence, this license obtained by the company "Kazpolmunay" encompasses oil transport **exclusively within the limits of contractual areas. "**
- (m) At the same time the pipelines recognized by the authorities of the Republic of Kazakhstan as trunk pipelines are outside the limits of the contractual area of the company "Kazpolmunay" (see Pipeline Scheme – Exhibit R-130).

itself up as a legal successor to a serious Soviet NII – The All-Union Scientific and Research Institute for Construction of Trunk Pipelines.

Such kind of structure seems strange.

May a joint-stock company act as a higher authority towards a limited liability company and approve its opinions? Approval is possible only within the system of administrative relations when a higher body approves the opinion of the inferior body or within the system of labour relations when the head approves an opinion of the employee after which it becomes the opinion of the organization. At the same time relations between joint-stock company and limited liability company can have only a civil law character.

However such kind of 'approval attributes the brand name of a reputable Soviet institute to the newly created in 2003.

It should also be indicated at the incorrect translation into the English language of a legal form in the signatures (**Exhibit C-107.3 and C-107.4**).

¹²⁷ **Exhibit C-45.2 and C-52.2.**

- (n) This means that the entire arguments of the Claimants based upon this fact have no legal ground.

21.6 Licensing of pipeline operation under the legislation of the Republic of Kazakhstan

In-field and trunk pipelines

- (a) In accordance with paragraph. 17 Article 1 of the Law of the Republic of Kazakhstan “On Oil” dated 28 June 1995 № 2350 (was in effect in 2008) under **oil pipelines** shall be meant pipelines intended for oil transport – trunk pipelines and pipelines which function as a gathering main as well as equipment intended for servicing such pipelines (**Exhibit R-23**).
- (b) This means that all pipelines in the Republic of Kazakhstan are divided into trunk pipelines and pipeline which operate as gathering main (in-field pipelines). The legislation of the Republic of Kazakhstan does not provide for any other pipelines (in contrast, for example, to the Russian legislation which provides in its SNiPs for connecting pipelines, i.e. pipelines connecting in-field pipelines with trunk pipelines).
- (c) The system of in-field pipelines in the Republic of Kazakhstan represents a gathering mine intended for collection of oil by the Contractor **within the limits of its field (contractual) territory of the Contractor** (outside the limits of its contractual territory – it is not a field any more). It is because of this that the in-filed pipeline is called in the legislation “Contractor’s pipeline”.

21.7 Definition of a trunk pipeline

- (a) In accordance with paragraph. 14 of Article 1 of the Republic of Kazakhstan “On Oil” of 1995 which was in effect in 2008 and other applicable normative acts¹²⁸ a **trunk pipeline**

¹²⁸ In line with paragraph. 14 Article 1 of the Law of the republic of Kazakhstan “On Oil” of 1995 which was in effect in 2008 a **“trunk pipeline** is an engineering structure intended for transportation of commercial oil from the places of production (from Contractor’s pipeline) **to the places of transshipment to a different means of transport, processing, consumption and storage» (Exhibit R-23).**

Similar definitions are contained in normative legal acts of a lower level: RD 39-033-02 “Rules of technical operation of trunk pipelines” and Enclosure 1 thereto; ST GU 153-39-167-2006 “Standards of technological design of trunk pipelines” (**Exhibit R-131**):

1) Basing on paragraph. 1.2.1 of RD 39-033-02 “Rules of technical operation of trunk pipelines” to trunk pipelines refer engineering structures consisting of a linear part and the related complex of underground, ground and above-ground facilities intended for transportation of **commercial oil** from the places of production **to the places of** associated with **магистральным нефтепроводам относятся инженерные сооружения, состоящие из transshipment to a different means of transport, processing or consumption.**

In accordance with Enclosure 1 to RD 39-033-02, a **trunk pipeline** is the Unified property and production and technological complex consisting of underground, underwater, ground and above-ground pipelines and associated pumping stations, oil

is an engineering structure intended for transportation of **commercial** oil from **the places of production (from Contractor's pipeline) to the places of**

- (i) transshipment to a different means of transport;
 - (ii) processing;
 - (iii) consumption
 - (iv) storage.
- (b) Thus:
- (i) A trunk pipeline is intended for transportation of commercial oil.
 - (ii) Transportation takes place from the places of production (the contractor's pipeline).
 - (iii) A trunk pipeline stretches beyond the contractual area (any pipeline which is beyond the contractual area is a trunk pipeline).
 - (iv) Transportation is carried out up to the places of
 - (A) transshipment to a different means of transport;
 - (B) processing;
 - (C) consumption
 - (D) storage

(Exhibit R-139)

Along with the above said a peculiar feature of an in-field pipeline as opposed to a trunk pipeline is the fact that an in-field pipeline is the contractor's pipeline under the contract for subsoil use and is intended solely for pumping its own oil. A trunk pipeline is usually used by its owner not only for pumping its own oil (if any), but also for rendering oil pumping services to other people.

storages and other technological facilities intended for oil transport from the points of its intake **to the point of its supply to consumers or for transshipment to another means of transport.**

2) Basing on paragraph. 3.19 of ST GU 153-39-167-2006 "Standards of technological design of trunk pipelines", a trunk pipeline is a uniform production and technological complex consisting of a linear part associated with pumping stations, oil storages and

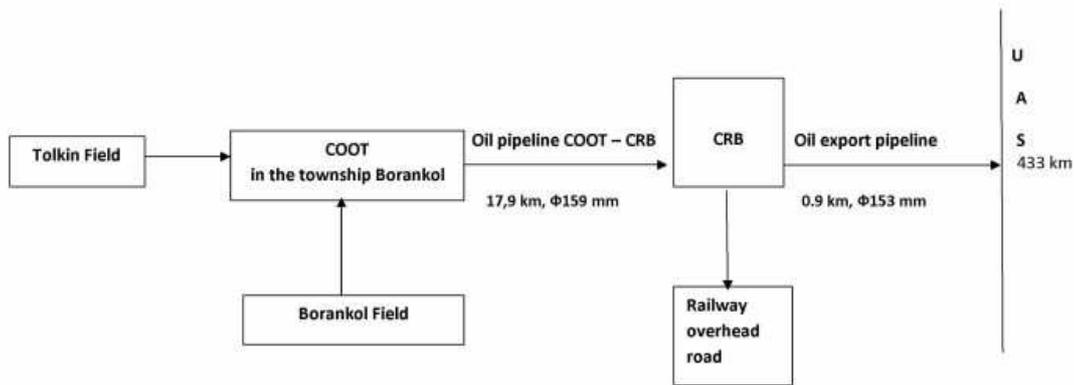
21.8 Pipelines and situation with the licenses of “Kazpolmunay” LLP

Scheme of transportation

- (a) TOO “Kazpolmunay” owns a network of pipelines.
- (b) Within the Borankol field there is a system of in-field pipelines. Through pipelines of different diameter and length the oil is supplied to an oil treatment plant (OTP) at the Central Processing Facility in the Centre of Oil Treatment and Transport (COTT). At the OTP the oil is degassed, dehydrated, desalinated and transformed into **commercial oil**.
- (c) The initial process is completed. Oil is extracted from wells and prepared for transit.
- (d) After that the oil is transported through the trunk oil pipeline “Borankol – Opornaya Station”.
- (e) This pipeline is a trunk pipeline since it is situated outside the contractual (field) area of “Kazpolmunay” LLP (“Borankol” contractual area).
- (f) Not only oil belonging to “Kazpolmunay” LLP is transported through this oil pipeline but also the oil belonging to another legal entity “Tolkynneftegaz” LLP operating in the a contractual area of “Tolkyn”. I.e. “Kazpolmunay” LLP renders services for transport of its oil to another legal entity.
- (g) This trunk pipeline consists of two sections:
 - (i) from the Centre of Oil Treatment and Transport to commodities and raw materials base (CRB), which is about 17 km long. At the CRB the oil is checked for compliance of oil quality with technical requirements of the organization which will carry out its further transport and, if necessary, adjusted to such requirements;
 - (ii) from the CRB to the oil pipeline KazTransOil “Uzen-Atyrau-Samara” (UAS) the oil is channeled through an extension of this oil pipeline which is about 1 km long for its subsequent supply to consumer by UAS pipeline, FOB Odessa (see paragraph 56 of the Statement of Claim).

Principal scheme of transportation

other technological facilities, intended for oil transport from the points of its intake **to the point of its supply to consumers or for transshipment to another means of transport”**.



On-site scheme see in **Exhibit R-130**

Specifications

- (h) A section of the pipeline “Borankol – Opornaya” was recognized by authorities as a trunk pipeline. This complies with the requirements of legislation.
 - (i) It is intended for transport of commercial oil
 - (ii) transportation is carried out from the place of production (from the Contractor’s pipeline).
 - (iii) It stretches beyond the limits of contractual area (any pipeline extending beyond the limits of a contractual area is a trunk pipeline).
 - (iv) It was used for rendering of the services to another legal entity.
 - (v) Transportation was carried out to the places of
 - (A)** transshipment to a different means of transport (agreements for oil transshipment to railway transport at the station Opornaya are enclosed – **Exhibit R-132**);
 - (B)** consumption (contracts for a transfer of ownership right to the oil at the moment of entrance to another trunk pipeline are enclosed – **Exhibit R-133**);

21.9 Acknowledgement by “Kazpolmunay” LLP of the fact that the pipeline is a trunk pipeline

- (a) It should be taken into account that in June 2008 “Kazpolmunay” LLP applied for the license for operation of trunk pipelines. The Claimants do not deny this. The letter signed

by Mr. Cornegruta - General Director of "Kazpolmunay" LLP - is enclosed (**Exhibit C-115**).

- (b) In July 2008 the licensing body answered that the submitted package of documents did not meet the requirements of legislation and suggested submitting the documents in accordance with the legislation (**Exhibit R-134**). After that "Kazpolmunay" LLP did not submit any documents.
- (c) Moreover, if the Claimants had some doubts concerning classification of the pipeline as a trunk pipeline it should have applied to a competent authority for explanation. In accordance with Article 26 of the Law of the Republic of Kazakhstan "On Prosecutor's Office" the Prosecutor's Office should give explanations on such kind of questions (**Exhibit R-126**).
- (d) Taking into account the aforesaid the Arbitral Tribunal should prohibit to the Investor on the basis of the principle of estoppel to use the argument that the pipeline allegedly was not a trunk pipeline. By its actions the Claimants earlier acknowledged that it is a trunk pipeline.

21.10 Similar pipelines

- (a) The Claimants have adduced the argument that the neighboring subsoil users – TOO "Kazakhturkmunay" and AO "KazMunaiGaz" Exploration and Production (called in the Statement of Claim as the state enterprise named "Kulsarynefti") operate similar pipelines without the license for carrying out the activity related to operation of trunk pipelines (paragraph. 80 of the Statement of Claim).
- (b) Meanwhile through pipelines of these organizations the oil is supplied only to the trunk pipeline of AO "KazTransOil" and there is no transshipment to railway transport as is the case in respect of "Kazpolmunay" LLP and as provided for in the definition of a trunk pipeline in the Law "On Oil". This is indicated in the letters of AO "KazMunaiGaz" Exploration and Production and TOO "Kazakhturkmunay" (**Exhibit R-135**).
- (c) In this connection pipelines of these organizations were not referred to the category of trunk pipelines and it is not correct to compare them with the pipeline of TOO "Kazpolmunay".

21.11 Obtaining of the license for the pipeline of "Kazpolmunay" LLP as to a trunk pipeline by the trust manager of the contractual area of Borankol deposit

- (a) At present the pipeline of TOO "Kazpolmunay" which is in temporary possession and use of the trust manager of the Borankol contractual area – a branch of AO MNK

“KazMunayTeniz” –is being operated on the basis of the license obtained by the trust manager (**Exhibit R-136**).

21.12 Concerning the existence of a large number of companies operating trunk pipelines and which activity is respectively licensed

- (a) The Claimants state that there are only a few companies in Kazakhstan that actually *do* hold licenses for operation of trunk pipelines, including Intergas Central Asia JSC, that operates the 4,892 kilometer long Central Asia- Center trunk gas transportation pipeline, and KazTransOil, that operates the 1,380 kilometer long trunk oil transportation pipeline (paragraph 80 of the Statement of Claim).
- (b) However a number of organizations operating trunk pipelines in Kazakhstan is not limited to some ten companies.
- (c) According to the data of the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan till 2008, when the licensor of all activities related to operation of a trunk pipeline was the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan, 94 licenses were issued to organizations for operation of trunk pipelines.
- (d) At present the licensor of the above mentioned type of licensed activity is the AREM. AREM issued to 95 organizations the license for operation of trunk pipelines, among which for carrying out the activity for operation of gas-trunk pipelines, oil trunk pipelines, oil-products pipelines to 21 organizations, for operation of equipment, units of booster pump stations, tank batteries and the linear part of gas mains and oil-product pipelines to 12 organizations. It should be noted that 14 organizations have carried out the procedure of re-issuance by the AREM of the licenses issued by the Ministry of Energy and Mineral Resources (**Exhibit R-137**).
- (e) Thus, in the Republic of Kazakhstan the licenses for operation of trunk pipelines hold over 100 enterprises.

21.13 Conclusion:

- (a) The pipeline concerned is a trunk pipeline which was acknowledged by the Claimants and requires the license for its operation.
- (b) “Kazpolmunay” LLP had no such license.
- (c) Hence over the whole period of operation of the above mentioned pipeline “Kazpolmunay” LLP carried out the licensed activity (operation of trunk pipelines) without

a license¹²⁹ which imposes an obligation on respective authorities to apply the enforcement measures to the guilty person.

FURTHER ANALYSIS

- 21.14 The Claimants allege that the Republic “reclassified” four pipelines owned by KPM and TNG as “trunk pipelines” as a pretext for pursuing KPM and TNG in respect of criminal charges. In turn, as a result of this wrong classification of the KPM pipeline, the local Kazakh courts conducted a “sham” trial of Mr Cornegruta, the managing director of KPM, resulting in his imprisonment and fines being levied against KPM. The Claimants allege that the charges brought against KPM were not justified since he is not an “entrepreneur” under the relevant legislation and the fine levied against KPM were unjustified because KPM was never brought into the criminal proceedings as a party.
- 21.15 Although the Claimants allege “reclassification” of four pipelines, the Claimants only rely on the Republic’s actions in relation to one pipeline (the 18km KPM oil pipeline (**KPM Pipeline**) to assert that there have been substantive breaches of the ECT.
- 21.16 The Claimants set out their factual assertions in paragraphs 79 - 139 of the Statement of Claim and the legal implications of such facts in Section VII. The legal allegations are addressed later in this Statement of Defence. In relation to the facts, the success of the Claimants’ legal allegations rests on demonstrating the following:

¹²⁹ We have considered only the situation in respect of TOO “Kazpolmunay”. This is explained by the fact that General Director of “Kazpolmunay” LLP Mr. S. Cornegruta was brought to criminal responsibility and “Kazpolmunay” LLP was exposed to penalties (the Claimant calls these facts “indirect expropriation”). A similar situation could have taken place with “Tolkynneftegaz” LLP which owned the trunk condensate pipeline which was also operated without a license. At the same time General Director of “Tolkynneftegaz” LLP Mr. A.Kozhin had hidden from law enforcement agencies. In which connection nobody was not brought to criminal responsibility.

Nevertheless from the scheme of condensate transport it may be unambiguously concluded that transportation was effected through the trunk pipeline “Borankol – Opornaya Station”.

Below is a brief description of this transportation which per se is identical to the above described oil transport.

1) There is a central gathering point of gas-condensate mixture at the “Tolkyn” deposit (TOO “Tolkynneftegaz”). This point is connected with the wells by a network of pipelines which are in-field pipelines and act as gathering lines.

2) Thereafter gas condensate is supplied by a 50 km long pipeline from the Gathering point of crude oil and gas condensate mixture at “Tolkyn deposit” to the treatment plant at the Treatment and Transport Centre (TTC) located at Borankol. Here the gas condensate mixture reaches the quality of condensate.

This pipeline does not fall within the framework of this dispute, so we are not interested in its legal qualification.

3) Here the initial procedure of collection of gas condensate mixture is completed.

4) The condensate is supplied to the station Opornaya by the condensate pipeline (UKPG - TSB) which is about 18 km long and which is also owned by TOO “Tolkynneftegaz”. This is a “disputed” condensate pipeline which is treated by the state authorities of the Republic of Kazakhstan as a trunk pipeline.

It is supplied to the supplier on FCA Opornaya basis and fed to railway tanks from oil loading rack.

- (a) The pipelines targeted for analysis were not “main¹³⁰” pipelines and therefore “main” pipeline licences were not required.
- (b) Mr Cornegruta was not an entrepreneur and, as such, could not be guilty of illegal entrepreneurial activity as alleged by the Republic.
- (c) KPM could not be subject to sanction as part of the criminal proceedings against Mr Cornegruta because it was not a party to the proceedings.
- (d) The trial of Mr Cornegruta was a sham.
- (e) The sentence imposed on Mr Cornegruta and/or the fine imposed on KMP were disproportionately harsh and not justified by the alleged offences.
- (f) The enforcement action taken against KPM in respect of the fine was unjustified and undertaken with the primary objective of disrupting KPM’s business to the detriment of the Claimants.
- (g) The actions of the Republic were arbitrary and discriminatory.

21.17 It is the Republic’s case that there was no “reclassification” of any of the pipelines. The pipelines were always trunk pipelines.

21.18 As set out at paragraph 20 above, the Republic had the rights and cause to monitor and investigate the activities of Subsoil contractors such as KPM and TNG. In exercising its powers investigating TNG and KPM, the Republic established that KPM (and, for that matter, TNG) did not have the licenses to operate trunk pipelines. This is acknowledged by the Claimants (see paragraph 80 of the SoC).

21.19 Since KPM in fact operated “trunk” pipelines in addition to “field” pipelines and did not have licences for such activities criminal charges were brought against KPM in the name of Mr Cornegruta, the general director of KPM at this time in accordance with Kazakh law.

21.20 The Aktau Court considered the charge against Mr Corengruta in accordance with Kazakh law and followed due process. The Court found against Mr Cornegruta on 18 September 2009 and sought restitution of the sums illegally earned by KPM during the period in which it operated illegally, without a licence.

21.21 As a result, KPM and Mr Cornegruta were brought to justice for illegal entrepreneurship (performing an activity which is to be licensed not having an effective licence) and KPM was fined in accordance with the Republic’s laws.

¹³⁰ The correct reference should be “trunk” pipelines

- 21.22 In any case, since KPM, acting via Mr Cornegruta, effectively admitted that the pipeline was a “trunk” pipeline, it can only now be in bad faith that the Claimants raise the argument that the pipeline was a “field” pipeline.
- 21.23 The enforcement activity taken against KPM was legitimate and taken with the objective of recovering and preserving assets, the value of which was to be used to discharge the fine.
- 21.24 The Claimants have funded to adequately demonstrate of (and if so, how) actions taken in respect of KPM’s illegal operation of the pipeline.

22 The Claimants position regarding KPM’s pipeline

- 22.1 The Claimants present the facts without any logic. It does not deny that in the Republic of Kazakhstan there existed an obligation to hold a license for the operation of a trunk pipeline (SoC 80).
- 22.2 At the same time they assert:
- (a) first, that KPM had the license for operation of pipelines (on this assertion almost all of KPM’s expert opinions are based); and
 - (b) second, the pipelines it operated were not trunk pipelines.
- 22.3 In support of the second assertion, they adduce solely technical arguments (see, for instance, paragraphs 85 and 86 of the Statement of Claim).
- 22.4 At the same time, the Claimants state that for determination of whether the pipeline is a trunk pipeline, the technical side is of no importance (**Exhibit C-108**).
- 22.5 The Claimants do not deny that they had applied for the license to operate trunk pipelines but failed to obtain it. The fact that the Claimants’ applied for the license renders their arguments in respect of the absence of the necessity of receipt of such license strange and unconvincing.
- 22.6 Moreover, they mislead the Tribunal stating that KPM’s pipeline allegedly was “reclassified” by the Republic of Kazakhstan from a field pipeline into a trunk pipeline (see, for example, paragraph 87 of the SoC) and that these actions were unlawful. In fact there was no re-classification of the pipelines. Simply in the course of the inspection the Republic found that KPM had no license for operation of trunk pipelines under the legislation of the Republic of Kazakhstan. As a result KPM was held liable for illegal entrepreneurship (carrying out of the licensed activity without a license).
- 22.7 According to G.V. Andreev:

“in violation of the legislation of the Republic of Kazakhstan on oil and contracts without amending them Stati has combined the production and technological processes of all companies, having in fact created a new subsoil user with a permanent body in the city of Kishinev (illegal entrepreneurial activity)” – (Exhibit R-34.1).

- 22.8 From this viewpoint the Claimants’ witness evidence is of interest. The witness statement of Cojin (paragraph 3): *“our infield pipelines”*. The witness statement of Romanosov: *“our pipelines for internal use”* (paragraph 13), *“three of our four infield pipelines of internal use”* (paragraph 21).
- 22.9 Even in its Statement of Claim, the Claimants do not realize that in terms of the legislation of the Republic of Kazakhstan, KPM and TNG are independent legal entities each of which has its own contractual territory. Even the mere fact that KPM rendered services to TNG for oil transport by its pipeline is indicative of the fact that this pipeline is not the field pipeline (since the field pipeline may in no circumstances be used for rendering the services for oil transport to third organizations).

23 Classification of pipelines under Kazakh law

- 23.1 The Aktau Court, Mangystau region determined that the pipeline owned by KPM was a “trunk” pipeline on 18 September 2009. The question of whether or not the pipeline is a trunk pipeline was considered carefully and disposed of by the Kazakh courts with reasons. The fully reasoned opinion is set out in the Claimants’ exhibit at C-117. The Republic’s judicial system dealt with this case fairly, transparently and in accordance with due process. The trial of Mr Cornegruta is dealt with fully below at Section 27.
- 23.2 The Arbitral Tribunal should not need to consider this question afresh since the Kazakh court’s decision does not, of itself, have a bearing on whether or not there has been a breach of the ECT.
- 23.3 That said, the Republic notes that the Claimants have devoted an entire witness statement (that of Mr Romanosov) and a number of paragraphs (paragraphs 79 - 87 of the Statement of Claim) to expressing their interpretation of the correct classification of pipelines. Unfortunately, the Claimants’ analysis is significantly flawed. Should the Arbitral Tribunal disagree with the Republic and consider it necessary to consider this question in detail for itself, then notwithstanding the court decision, the Republic is compelled to highlight the manner in which the Claimants have erred in reaching the conclusion they have in respect of the pipeline. Thus the arguments set out below, respond to the arguments raised by the Claimants in the Statement of Claim. In this regard, since the Claimants appear only to rely on the “reclassification” of the KPM Pipeline, the substance of the Republic’s answer primarily considers the events relating to this pipeline.
- 23.4 The Claimants’ central assertion, at paragraph 80 of the Statement of Claim is that neither KPM nor TNG ever owned or operated a “trunk” pipeline and that the Republic arbitrarily reclassified

KPM's and TNG's pipelines as "trunk" pipelines. In the Statement of Claim, the Claimants identify certain considerations they consider relevant to support including:

- (a) Trunk pipelines are defined by reference to the Article 1(14) of the Law on Oil of the Republic of Kazakhstan dated 28 June 1995 (**Exhibit C-180**).
- (b) Construction, operational and safety specifications are relevant for the characterisation of the pipeline (paragraph 82 of SoC).
- (c) The Republic approved the design and construction of the pipelines issuing permits and issued further permits in 2002 and 2005 (paragraph 83 of SoC).
- (d) Size (by reference to length and diameter) is relevant to the classification of the pipeline (paragraphs 85 and 86 of the SoC).
- (e) Notwithstanding (a) above, the view of a technical engineer or a layperson is relevant in correctly characterising the pipeline (paragraph 85 of the SoC).

23.5 The Republic accepts the relevance of Article 1(14) of the Law "On Petroleum" 1995, but denies that the other factors are determinative of the question of whether a pipeline is a trunk pipeline, as discussed in greater detail below.

23.6 The question of whether the pipelines operated by KPM and TNG are field or trunk pipelines is a matter of the correct application of the relevant Kazakh legislative instruments. The following restates and expands on the reasoning recorded in the judgment of the Kazakh court.

Legal Definitions

23.7 In accordance with paragraph 17, Article 1 of the Law of the Republic of Kazakhstan "On Petroleum" dated 1995 (which was still in effect in 2008) oil pipelines shall be meant pipelines intended for oil transport, including trunk pipelines and pipelines which function as a gathering system as well as equipment intended for servicing such pipelines (**Exhibit R-23**).

23.8 This means that all pipelines in the Republic of Kazakhstan are divided into trunk pipelines and pipelines which operate as a gathering system (in-field pipelines). The legislation of the Republic of Kazakhstan does not provide for any other pipelines (in contrast, for example, to the Russian legislation which provides in its SNIPs for connecting pipelines, i.e. pipelines connecting in-field pipelines with trunk pipelines).

23.9 The system of in-field pipelines in the Republic of Kazakhstan represents a gathering system intended for collection of oil by the Contractor within the limits of its field (contractual) territory of the Contractor (outside the limits of its contractual territory – it is not a field any more). It is because of this that the in-field pipeline is called in the legislation "Contractor's pipeline".

23.10 The question of whether KPM's and TNG's pipelines are trunk pipelines is principally a question of legal interpretation. Article 1(14) of the Law "On Petroleum" of the Republic of Kazakhstan as of 1995 and other applicable normative legal acts¹³¹ refer to a transfer / trunk pipeline as follows:

"Main pipeline - means an engineering construction, consisting of a linear part and related aboveground facilities, services lines, remote control and communication facilities, which designated for transportation of oil from contractor's pipeline to the points of transshipment to another mode of transport, or points of processing or consumption. Pipelines operating in the gathering main mode shall not be referred to as main pipelines" (Exhibit C-80).

23.11 Therefore, to summarise, a **trunk pipeline** is an engineering structure intended for transportation of **commercial oil from the places of production (from Contractor's pipeline) to the places of:**

- (a) transshipment to a different means of transport;
- (b) processing;
- (c) consumption; and
- (d) storage.

23.12 Thus:

- (a) A trunk pipeline is intended for transportation of commercial oil.
- (b) Transportation takes place from the places of production (the contractor's pipeline).
- (c) A trunk pipeline stretches beyond the contractual area (any pipeline which is beyond the contractual area is a trunk pipeline).

¹³¹ In line with paragraph 14 Article 1 of the Law of the republic of Kazakhstan "On Petroleum" of 1995 which was in effect in 2008 a "main pipeline is an engineering structure intended for transportation of commercial oil from the places of production (from Contractor's pipeline) to the places of transshipment to a different means of transport, processing, consumption and storage» (Exhibit R-23).

Similar definitions are contained in normative legal acts of a lower level: RD 39-033-02 "Rules of technical operation of main pipelines" and Enclosure 1 thereto; ST GU 153-39-167-2006 "Standards of technological design of main pipelines" (Exhibit R-131):

1) Basing on paragraph 1.2.1 of RD 39-033-02 "Rules of technical operation of main pipelines" to main pipelines refer engineering structures consisting of a linear part and the related complex of underground, ground and above-ground facilities intended for transportation of commercial oil from the places of production to the places of associated with магистральным нефтепроводам относятся инженерные сооружения, состоящие из transshipment to a different means of transport, processing or consumption.

In accordance with Enclosure 1 to RD 39-033-02, a main pipeline is the Unified property and production and technological complex consisting of underground, underwater, ground and above-ground pipelines and associated pumping stations, oil storages and other technological facilities intended for oil transport from the points of its intake to the point of its supply to consumers or for transshipment to another means of transport.

2) Basing on paragraph 3.19 of ST GU 153-39-167-2006 "Standards of technological design of main pipelines", a main pipeline is a uniform production and technological complex consisting of a linear part associated with pumping stations, oil

(d) **Transportation is carried out up to the places of:**

- (i) transshipment to a different means of transport;
- (ii) processing;
- (iii) consumption; and
- (iv) storage.

23.13 Along with the above points, a peculiar feature of an in-field pipeline as opposed to a trunk pipeline is the fact that an in-field pipeline is the contractor's pipeline under the contract for subsoil use and is intended solely for pumping its own oil. A trunk pipeline is usually used by its owner not only for pumping its own oil (if any), but also for rendering oil pumping services to other people.

23.14 The Claimants assert at paragraph 80 of the Statement of Claim that construction, safety and operational standards under Kazakh law are also relevant to the consideration of whether a pipeline is "field" or "trunk". It is not denied that such definitions give helpful guidance on the definition of what constitutes a "trunk" pipeline, however construction specifications are not in themselves relevant to the assessment of whether or not a pipeline is "trunk" or "field".

23.15 It will be apparent from the above discussion of the definition of trunk pipeline that the definition is substantially dependent for its operation in identifying the point at which the "contractor's pipeline ends" as a trunk pipeline exists between that point and the point of transfer to another mode of transport or the point of processing or consumption. In that regard the geographical limits of the Contractors Area under the relevant Subsoil use should be considered.

23.16 In relation to KPM and TNG, this information is set out at paragraph 13.52 and 14.20 above.

Irrelevance of many of the Claimants' arguments as to why KPM's and TNG's pipelines are not trunk pipelines

23.17 From the preceding discussion, it can be seen that the question of whether a pipeline is a "trunk pipeline" is principally a legal question decided by reference to the definition of "trunk pipeline" contained Article 1(14) of the Law "On Petroleum" 1995, which is primary legislation.

23.18 However, in arguing that KPM's and TNG's pipelines are not trunk pipelines, the Claimants rely on a number of other factors:

storages and other technological facilities, intended for oil transport from the points of its intake to the point of its supply to consumers or for transshipment to another means of transport".

- (a) The fact that KPM and TNG were never licensed to operate a trunk pipeline and instead held licences appropriate for field pipelines (SoC 80 and 83).
- (b) The pipelines were designed and constructed standards applicable to field pipelines (SoC 83).
- (c) The pipelines were approved by State agencies during and on completion of construction (SoC 83).
- (d) The KPM and TNG pipelines are shorter and of smaller diameter to the Central Asia - Centre and Uzen - Atyrau - Samara trunk pipelines (SoC 85 and 86).
- (e) No claim was brought against Kulsarynefty or KazakhTurkMunai LLP which own pipelines which nearby/parallel to KPM's and TNG's pipelines (SoC 87).
- (f) Very few companies in Kazakhstan hold licences to operate trunk pipelines (SoC 80).

23.19 Dealing with each in turn:

- (a) As regards KPM's and TNG's licences, the activities for which a licensee holds a licence are not determinative of the activities which that licensee carries out. The boundaries of the licence merely describe the boundaries of lawful activity. Therefore the fact that KPM and TNG did not have a licence to operate a trunk pipeline is in no way relevant to whether or not those companies in fact owned and operated such a pipeline.
- (b) As regards the standards to which the pipelines was designed and constructed, the definition of trunk pipeline is established by reference to primary legislation and as a matter of principle construction standards and other secondary or tertiary legislation cannot derogate from the position established by primary legislation. Further, the definition of trunk pipeline in the Law "On Petroleum" 1995 is not concerned with the particular standards to which a pipeline is constructed. Rather it is concerned with its location and the use to which it is put. In any event Mr Baymaganbetov's report dated 13 February 2009 (**Exhibit C-110**), that was prepared for the Ministry of Justice in connection with the trial of Mr Cornegruta, effectively concludes that there is nothing about the construction of KPM's pipeline which is inconsistent with its classification as a trunk pipeline.
- (c) As regards State approval to the construction of a pipeline, the Claimants do not explain the nature of these approvals or provide copies of them. It has no basis therefore to argue that the pipelines are not trunk pipelines. It is beyond doubt that the Central Asia - Centre and Uzen - Atyrau - Samara received 'approvals' from the State and they are trunk pipelines.

- (d) As regards the length and diameter of a pipeline, as with the standard of construction, size is not a factor in the definition of trunk pipeline in the Law “On Petroleum” 1995. Further, as is apparent from the report of Mr Baymaganbetov (**Exhibit C-110**) the classification of trunk pipelines caters for pipelines with a diameter of 1200m right down to 300mm and less. Based on those classifications, KPM’s and TNG’s trunk pipelines are classes 4 and 3 respectively.
- (e) As regards the operation of similar pipelines be the neighboring subsoil users – “Kazakhturkmunay” LLP and “KazMunaiGaz” Exploration and Production JSC (referred to in the Statement of Claim as the state enterprise named “Kulsarynefty”) without the license for carrying out the activity related to operation of trunk pipelines (paragraph 87 of the Statement of Claim).
- (f) Meanwhile through pipelines of these organizations the oil is supplied only to the trunk pipeline of AO “KazTransOil” and there is no transshipment to railway transport as is the case in respect of “Kazpolmunay” LLP and as provided for in the definition of a trunk pipeline in the Law “On Petroleum” 1995 (**Exhibit R-16**). This is indicated in the letters of “KazMunaiGaz” Exploration and Production JSC and “Kazakhturkmunay” LLP (**Exhibit R-135**).
- (g) In this regard, pipelines of these organizations were not referred to in the category of trunk pipelines and it is not correct to compare them with KPM’s pipeline.
- (h) Further, as regards to assertions in SoC paragraph 87 no action has been taken against Kulsarynefty or KazakhTurkMunai LLP:
 - (i) Firstly, the absence of State action against these companies is irrelevant to the classification of KPM’s pipeline by reference to the Law “On Petroleum” 1995.
 - (ii) Second, the physical similarity of the construction of the pipelines is irrelevant for the reasons given in (d) above.
 - (iii) Third, whilst the location of a pipeline is relevant to its classification, there is nothing to indicate and the Claimants provide no evidence that the pipelines of Kulsarynefty and KazakhTurkMunai LLP are outside the Contract Area of their respective Subsoil Contracts.
 - (iv) Fourth, even if the pipelines of Kulsarynefty and KazakhTurkMunai LLP are trunk pipelines, the Claimants do not allege or prove that those companies do not hold licences to operate trunk pipelines.
- (i) As regards the Claimants’ assertion that there are only a few companies in Kazakhstan that actually do hold licenses for operation of trunk pipelines, they refer only to Intergas

Central Asia JSC, that operates the 4,892 kilometer long Central Asia- Center trunk gas transportation pipeline, and KazTransOil, that operates the 1,380 kilometer long trunk oil transportation pipeline (SoC 80).

- (j) However a number of organizations operating trunk pipelines in Kazakhstan is not limited to some ten companies.
- (k) According to the data of the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan till 2008, when the licensor of all activities related to operation of a trunk pipeline was the Ministry of Energy and Mineral Resources of the Republic of Kazakhstan, 94 licenses were issued to organizations for operation of trunk pipelines.
- (l) At present the licensor of the above mentioned type of licensed activity (the AREM) has issued licences to 95 organizations for operation of trunk pipelines, among which for carrying out the activity for operation of gas-trunk pipelines, oil trunk pipelines, oil-products pipelines to 21 organizations, for operation of equipment, units of booster pump stations, tank batteries and the linear part of gas mains and oil-product pipelines to 12 organizations. It should be noted that 14 organizations have carried out the procedure of re-issuance by the AREM of the licenses issued by the Ministry of Energy and Mineral Resources (**Exhibit R-137**).
- (m) Thus, in the Republic of Kazakhstan the licenses for operation of trunk pipelines hold over 100 enterprises.

23.20 As regards technical aspects of KPM's pipeline, such as length, diameter, and construction method it is noteworthy that the Claimants own evidence provided by Mr Suleymenov (**Exhibit C-108**, page 5) states that:

“Taking into consideration technical aspects there is no difference between gas and oil pipelines including transfer and non-transfer pipelines without limitations because transfer and non-transfer Construction pipelines are the pipelines used to transfer oil taking into consideration technical aspects. Safety requirements on operating of transfer and non-transfer pipelines foreseen in different Norms and Specifications, regulation etc. for transfer and non-transfer pipelines may coincide because these requirements are determined by their technical characteristics (physical and chemical parameters, pipe diameter, pressure tolerance, required engineering constructions and other technical solutions to provide safety of operating etc.)”.*

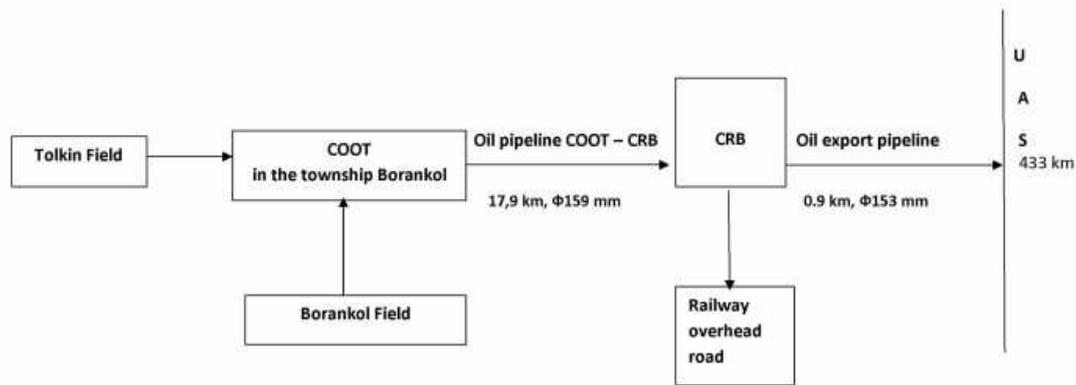
23.21 Indeed, the expert evidence of Mr Suleymenov, calls into question what authority Mr Romonasov, the Technical Director of both KPM and TNG, had to comment on whether the pipeline was “trunk” or “field”. This knowledge of the technical specifications and physical characteristics of the

pipelines in relation to the project on which he worked for 10 years is likely to be extensive. However, the issue is one of interpretation of the legal definition of trunk pipeline and the Claimants are put to proof as to how this knowledge alone assists Mr Romanasov in assessing the legal classification of the pipeline. In this respect, the Republic notes that his principal experience has, to date, involved the drilling of wells, rather than the construction or, moreover, the classification of the pipelines.

24 Function and purpose of KPM's pipelines

- 24.1 KPM owns a network of pipelines.
- 24.2 Within the Borankol field there is a system of in-field pipelines. Through pipelines of different diameter and length the oil is supplied to an oil treatment plant (**OTP**) at the Central Processing Facility in the Centre of Oil Treatment and Transport. At the OTP the oil is degassed, dehydrated, desalinated and transformed into commercial oil.
- 24.3 The initial process is completed. Oil is extracted from wells and prepared for transit.
- 24.4 After that the oil is transported through the trunk oil pipeline "Borankol – Opornaya Station".
- 24.5 This pipeline is a trunk pipeline since it is situated outside the contractual (field) area of KPM ("Borankol" contractual area).
- 24.6 Further it is not only oil belonging to KPM which is transported through this oil pipeline but also the oil belonging to another legal entity TNG, operating in the contractual area of "Tolkyn". Therefore KPM provides services for transport of its oil to another legal entity.
- 24.7 This trunk pipeline consists of two sections:
- (a) from the Centre of Oil Treatment and Transport to commodities and raw materials base (**CRB**), which is about 17 km long. At the CRB the oil is checked for compliance of oil quality with technical requirements of the organization which will carry out its further transport and, if necessary, adjusted to such requirements;
 - (b) from the CRB to the oil pipeline KazTransOil "Uzen-Atyrau-Samara" (UAS) the oil is channelled through an extension of this oil pipeline which is about 1 km long for its subsequent supply to consumer by UAS pipeline, FOB Odessa (see paragraph 56 of the Statement of Claim).

Principal scheme of transportation



On-site scheme see in **Exhibit R-130**

Specifications:

24.8 A section of the pipeline “Borankol – Opornaya” was recognized by authorities as a trunk pipeline. This complies with the requirements of legislation.

- (a) It is intended for transport of commercial oil
- (b) Transportation is carried out from the place of production (from the Contractor’s pipeline).
- (c) It stretches beyond the limits of contractual area (any pipeline extending beyond the limits of a contractual area is a trunk pipeline).
- (d) It was used for rendering of the services to another legal entity.
- (e) Transportation was carried out to the places of
 - (i) transshipment to a different means of transport (agreements for oil transshipment to railway transport at the station Opornaya are enclosed – (**Exhibit R-132**);
 - (ii) consumption (contracts for a transfer of ownership right to the oil at the moment of entrance to another trunk pipeline are enclosed – (**Exhibit R-133**);

24.9 In conclusion, it can clearly be seen that the KPM pipeline is a trunk pipeline for the following reasons:

- (a) As recognised by the Aktau City Court the KPM pipeline extends beyond the Contract Area of KPM’s Subsoil Contract and is therefore not a “contractor’s pipeline”.
- (b) As recognised by the Aktau City Court (**Exhibit C-117** page 9) commercial oil is transported through the pipeline to the UAS pipeline en route to places of transshipment and/or consumption.

- (c) The pipeline transports TNG's oil as well as KPM's oil. In other words, KPM provides services on pumping his oil to another legal person and therefore it cannot be a trunk pipeline.

25 Requirement to licence trunk pipelines

25.1 The licensing of pipelines has consistently and transparently been required under the Republic's laws as follows:

- (a) In accordance with the Law of the Republic of Kazakhstan "On Licensing" as of April 17, 1995 No. 2200, "*operating of transfer gas and oil pipelines*" was subjected to licensing.
- (b) As KPM's expert Mr Suleymenov recognises (**Exhibit C-108** page 6) Article 4 "On Natural Monopolies" (**Exhibit R-127**) of the legislation of the Republic of Kazakhstan as of 9 July 1998 No. 272 refers to operation of a trunk pipeline. A legal entity operating such pipeline is considered as the subject of natural monopoly and falls under special licensing. At present such licensing is provided for by Article 12 of the Law of the Republic of Kazakhstan "On Licensing" № 214 of 11 January 2007 (**Exhibit R-24**).
- (c) The functions of licensing of operation of gas trunk pipelines, oil pipelines, oil-product pipelines were transferred in accordance with the Decree of the President of the Republic of Kazakhstan of 19 June 2007 № 346 "On Further Improvement of the System of State Management of the Republic of Kazakhstan" to the Agency of the Republic of Kazakhstan for Regulation of Natural Monopolies (**Exhibit R-128**) to which the Claimant applied unsuccessfully for a licence.

Obtaining a licence

- 25.2 Prior to 2007, the MEMR was responsible for issuing licenses to operate transfer gas pipelines, oil pipelines and oil product pipelines. Since 2007, the Agency on Regulating of Natural Monopolies of the Republic of Kazakhstan has had the power of issuing licenses to operate transfer gas pipelines, oil pipelines and oil product pipelines in accordance with the Decree of the President of the Republic of Kazakhstan as of 19 June 2007 № 346 "*On further improvement of system of state management of the Republic of Kazakhstan*" (**Exhibit R-128**). In order to obtain a licence, an application supported by the relevant documents must be submitted to the relevant body for consideration. (**Exhibit C-117** page 6)
- 25.3 The Claimants must have and ought to have been aware of these requirements, which predated their alleged investments into Kazakhstan. It is notable that they do not deny that a licence was required.

25.4 At present KPM's pipeline, which is in temporary possession and use of the trust manager of the Borankol contractual area, a branch of "KazMunayTeniz" Sea Oil Company" JSC, is being operated on the basis of the license obtained by the trust manager (**Exhibit R-136**).

KPM and TNG's licences did not cover trunk pipelines

25.5 The Claimants' central assertion is that KPM and TNG never owned or operated a "trunk" pipeline.

25.6 It is a surprising omission and a significant flaw in the Claimants' submissions that they do not adequately particularise whether or not the licences that they were granted covered its activities in relation to the pipelines, which it alleges are "field" pipelines. It is revealing that, instead, on the Claimants' argument, it agrees that the licences it had, never covered "trunk" pipelines (paragraph 80 of SoC).

25.7 In the MEMR's assessment of the licences in November 2008, it was found that:

"The...licences...do not give them the right to activity on operation of the main: gas pipelines, oil pipelines and oil products pipelines." (**Exhibits C-86 and C-87**)

25.8 Instead of challenging this statement, the Claimants rely on witness evidence to agree with the assessment of KPM and TNG. Thus, Mr Cojin notes that *"Technically speaking, the...statement the Financial Police added was not inaccurate: since KPM and TNG did not operate a main pipeline, they were not obliged to have licences to operate such pipelines."* (Paragraph 5, Cojin's Witness Statement).

25.9 As demonstrated above, since the pipeline was in fact a trunk pipeline and it is clear from the Claimants' own admission that they did not have a licence to cover such activity, the Claimants' assertion that the KPM pipeline was, in fact, a "field" pipeline rings hollow.

KPM admitted that that its pipeline was a trunk pipeline

25.10 Moreover, in any event, the Claimants' entire allegation in respect of the trunk pipeline loses credibility in the face of the fact that KPM itself admitted that the KPM pipeline was a "trunk" pipeline.

25.11 In June 2008, KPM applied for a licence in respect of the exploitation of trunk pipelines. The Claimant does not deny this (**Exhibit C-115**). In its letter KPM (represented by Mr Cornegruta) states that it was applying for the "re-issuance" of its licence 004178 in respect of the *"use of equipments, the pumping - compressions plants facilities, of the tank farms and of the linear sector on the main gas and oil products pipe lines, as well as technological equipments."*

25.12 In July 2008, the competent licensing body replied that the submitted package of documents does not correspond to applicable legal requirements and recommended that KPM submit the

documents again in accordance with the legislation (**Exhibit R-134**). After that, KPM failed to submit any documents.

- 25.13 The Claimants had every opportunity to seek clarification as to whether its pipeline was a “trunk” or a “field” pipeline. If the Claimant had any doubts whether the pipeline was a trunk pipeline, KPM should have addressed the competent body for clarification. In line with Article 26 of the Law of the Republic “On Public Prosecutor's Office” the public prosecutor's office is obliged to provide such clarifications (**Exhibit R-126**). This is yet another example of the Claimants' failure to take advantage of the local law mechanisms available to them.
- 25.14 In bad faith, the Claimants have ignored this admission by KPM and the Claimants are estopped from resorting to the argument that the pipeline, allegedly, was not trunk. The Claimant by his previous actions admitted that it is trunk.

26 Pre-trial Investigations by the Financial Police

- 26.1 At paragraphs 88 to 97 of the Statement of Claim, the Claimants criticise the Financial Police's investigation of the classification of KPM's and TNG's pipelines. The Claimants allege that the Financial Police wrongly and spuriously “reclassified” KPM's and TNG's pipelines simply in order to give it a basis for asking the Fiscal Committee to calculate a figure with which to allege that illegal profits were payable by KPM and TNG. That figure was, the Claimants assert, reached as a result of “*exceedingly crude*” calculations and, the Claimants protest, amounts to all of KPM's and TNG's oil and gas condensation for 2005 to 2007.
- 26.2 Moreover, they say the Financial Police pursued the criminal charge in a “*dogged*” manner. In particular, the Claimants focus on (i) the withdrawal of an opinion sought by the Claimants and given by the Ministry of Emergency Situations at the request of the Financial Police, and (ii) the manner of the investigation and questioning of the General Manager of KPM the Deputy Manager of KPM and TNG on 25 December 2008.
- 26.3 Lastly, the Claimants allege that their complaints against the Financial Police's actions were ignored.
- 26.4 The Republic denies the allegations. The Republic's position is as follows:
- (a) The Financial Police were empowered to investigate the legislative basis of TNG's and KPM's activities and did so validly. This is discussed in detail at Section 19.
 - (b) The Financial Police sought further information from the Agency for Regulation of Natural Monopolies (**ARNM**), the competent authority in relation to the licensing of trunk pipelines (among other activities). The MES, from whom the Claimants' sought a “second opinion” is not the competent authority.

- (c) Once the Financial Police discovered that the Claimants were operating a trunk pipeline without the relevant licence, in breach of article 190(2) of the Criminal Code of the Republic of Kazakhstan, it proceeded to carry out the necessary steps to bring about all the elements of the relevant criminal prosecution.
- (d) The calculation of the “illegal profits” was correct. In relation to KPM, such calculation was confirmed by the Kazakh courts and is, therefore, beyond further scrutiny.

26.5 In any event, the Claimants have presented no evidence which suggests that the actions of the Financial Police were in any way inappropriate or contrary to their powers. In fact, the material that the Claimants have exhibited demonstrates the proper manner in which the Republic went about its investigations. For this reason, much of the factual content of paragraphs 88 to 97 is admitted. Further, the Claimants have failed to adequately demonstrate if (and if so, how) this affected their alleged investments.

26.6 Nor has any proper assessment as to the “correct” way of assessing “illegal profits” been presented by the Claimants.

26.7 Far from being a complaint regarding the improper conduct of the Financial Police, the complaint here appears to relate the unpalatable consequences of the Financial Police identifying illegal non-licensed activity. Moreover, through the use of emotive language to describe the Financial Police’s actions, there appears to be a cynical (and strategic) attempt to create an unfavourable view of the Financial Police who conducted their investigations in accordance with their powers.

26.8 The MEMR conducted an investigation of the pipelines in accordance with article 37 of the “Law On Oil” and article 51- of the Law “On Subsoil Use” on 11 November 2008. As to paragraph 89 (C86):

- (a) As the minutes record (**Exhibit C-86 and C-87**), the Financial Police also attended this meeting pursuant to Order No. 50588/10.14th 2008 from the President and following a specific order to investigate dated 28 October 2008 (cited in Exhibit C-89). It is denied that the Financial Police’s presence at the meeting was improper (as alleged by Mr Pisica, paragraph 13). Notably, the ARNM was not present at the investigation.
- (b) The MEMR reports contain the results of their investigations and describe the physical territory as well as the history of the field and the status of KPM’s / TNG’s compliance with the contractual obligations (**Exhibit C-86 and C-87**). As the Claimants assert, both reports include statements that:
 - (i) the ARNM had confirmed that KPM and TNG had licences to carry out the operation of industrial explosive and fire hazard works and mining facilities, elevating constructions, and also coppers, vessels and the pipe lines working under pressure, drillings for oil and gas; and

(ii) that the licences do not give KPM and TNG the right to use the trunk gas pipelines, oil pipelines and oil - products pipelines. As set out above, the Claimants do not contest this statement.

(c) Curiously, notwithstanding that the Claimants accept the statement, the Claimants point to witness evidence (Mr Cojin, paragraphs 4 and 5) that, they say, suggests that the Financial Police pressurized the MEMR to include this statement in the MEMR report. This is denied and the Claimants are put to proof as to the significance of this observation. If it is the Claimants' case that this statement was inserted at the request of the Financial Police, the Republic's position is that it is entirely appropriate for the Financial Police to opine on matters of legislative interpretation (such as, in this instance, the applicability of the licence to the pipeline in question).

26.9 As to paragraph 90 of the SoC, the Financial Police requested further information from the ARNM on 12 November 2008 following the site visit. This was simply a request as to whether or not, as a matter of fact, TNG and KPM held licences for trunk pipelines. (**Exhibit C-88**)

26.10 On 14 November 2008, the ARNM confirmed that the licences held by KPM and TNG did not cover "trunk" pipeline activity and in addition, that the operation of trunk pipelines was an activity that needed to be licensed under Law No 214 of 11 January 2007.¹³²

(a) As explained by an expert of the ARNM, the response from ARNM on 14 September 2008 stated that KPM and TNG had indeed applied for trunk pipeline licences in July 2008, but that both these were denied by the ARNM (**Exhibit C-88**).

(b) As set out above, since 26 March 2008 (and further to the President's Decree dated 19 June 2007), the ARNM was the competent authority in respect of licensing of certain types of activities, and in particular in relation to the use of oil and gas processing facility, use of oil and gas, oil and oil products storage facilities, trunk pipelines, oil products pipelines (**Exhibit C-88**). As mentioned above, this is entirely appropriate since trunk pipelines are considered to be natural monopolies under Kazakh law.

(c) Far from being a "curious enquiry" it was entirely proper for the Financial Police to approach the ARNM to confirm whether or not trunk pipeline licences had been issued KPM and / or TNG. KPM was fully aware of the ARNM's authority in relation to trunk pipelines, as it had addressed its letter for the re-issuance of its licence to ARNM some months before the investigation took place (**Exhibit C-115**).

26.11 Accordingly, operating within its powers and following a physical assessment of the KPM and TNG pipelines, the Financial Police simply identified that the pipelines that KPM and TNG were

¹³² Exhibits R-24

operating were not in accordance with the licences that the companies held. How this amounts to a “reclassification” is not understood by the Republic, nor does the evidence (the order from the Financial Police to the Tax Committee to carry out a valuation in relation to illegal profits) shed any light on this point.

26.12 As to paragraph 91 of the SoC, it is not clear why KPM and TNG thought it necessary to approach the Ministry of Emergency Situations (**MES**) for a second opinion on the issue. It is admitted that MES’s responses to KPM and TNG on 19 November 2008 stated that “all the pipelines” operated by both enterprises were not trunk pipelines. (**Exhibit C-90**)

(a) However, the MES is not the competent body in relation to the classification of the pipelines and therefore has no competence to assess or interpret the legislation (**Exhibit R-189**). Given this, on 21 November 2008, the Financial Police requested that the MES withdraw its statements, clarifying that “*the licence necessary for the exploitation of the gas, oil and oil product trunk lines has not been issued to KPM and TNG up to the present day by ARNM.*” (**Exhibit C-92**) The MES duly revoked its letters (**Exhibit C-92 and C-93**).

(b) The Republic is not clear what the significance of the Claimants’ assertion that the MES “*eventually relented*” from its original statements. The date on which it sent its response is of no significance since its statement had no weight or authority in any case.

26.13 Following the field trip to KPM and TNG on 11 November 2008 and the confirmation from the MEMR that KPM and TNG do not hold “trunk” pipeline licences, the Financial Police had good reasons to suspect that the use of “trunk” pipelines without a relevant licence constituted illegal activity contrary to section 190(2)(b) of the Criminal Code of the Republic of Kazakhstan (Law No 167) dated 16 July 1997 (as amended) which prohibits illegal entrepreneurial activity (**Exhibit R-58**).

26.14 The details of the criminal proceedings themselves are set out fully below at paragraph 27. The most pertinent features of the relevant legislation are as follows:

(a) The Criminal Code of the Republic of Kazakhstan does not envisage the prosecution of companies, only individuals. It is therefore not possible to bring criminal charges against a company in Kazakhstan (as the Claimants acknowledge at paragraph 114 of the Statement of Claim) (**Exhibit R-58**).

(b) Section 190 of the Criminal Code of the Republic of Kazakhstan forms part of Chapter 7, Crimes in the Sphere of Economic Activity.

- (c) Liability under article 190 will arise where entrepreneurial activity occurs without a licence and is punishable by a deduction from wages, fine, imprisonment or all three of the above.¹³³
- (d) Where there has been excessive illegal revenue gained from the activity this enables, the penalties are the same (deduction of wages, imprisonment and / or fines), but more severe.
- (e) The relevant subject of the crime is an “entrepreneur” as defined in the legislation and, in practice, the General Director or similar senior managers of the company can fall into this category.

- 26.15 There is no good reason why any foreign investor making substantial investments would not be appraised of the basic provisions of any legislation pertinent to its investments. It follows that the Republic was entitled to expect, indeed had a legitimate expectation that KPM and TNG and its investors would be appraised of laws relevant to them.
- 26.16 Separately (and in summary), under Article 19 of the Regulatory Resolution of the Supreme Court of the Republic of Kazakhstan as of June 18, 2004 (**Exhibit R-144**) and Article 921 of the Civil Code of the Republic (**Exhibit R-8**), a company must return any property illegally accrued by its employees to the State. In this case, such property constitutes the revenue that KPM and TNG accrued or acquired through the illegal operation of the trunk pipelines.
- 26.17 With these provisions in mind the Financial Police initiated investigations in order to gather the relevant information for its case. Some of the key features of the pre-trial investigation and, in particular, those highlighted by the Claimants as examples of the “*dogged pursuit*” by the Financial Police, are set out below.
- 26.18 Firstly, the Financial Police ordered the Tax Committee to “*calculate the amount of obtained income upon the development of illegal economic activity*” for the exploitation period of TNG and KPM as authorised by article 9(1) of the law “*concerning the organs of the financial police*” No. 336-II/07.04th, 2002 (**Exhibit C-89**).
- 26.19 The Tax Committee rendered its calculation in accordance with the Financial Police’s request. In respect of TNG, it issued a decision on 19 November 2008 that during the period from 2005 to 2007, 733.05 thousand tons of gas were transported through the relevant pipeline rendering an overall revenue of 37,672,263.1 thousand tenge. Its calculations were based on the accounting information provided by TNG itself (**Exhibit C-202**).

¹³³ Exhibit R-58

- 26.20 Secondly, on 24 December 2008, in relation to KPM, the Financial Police requested KPM (by letter) to provide certain information regarding (a) the level of protection of the company, and (b) sales made by KPM to agents, individuals and other businesses (**Exhibit C-94**). The letter was not, as the Claimants assert in paragraph, a notice that *“KPM...was the subject of a criminal investigation for operating a pipeline without a license.”* That would be nonsensical under Kazakh law.
- 26.21 Thirdly, on 25 and 26 December 2008, Mr Cornegruta, the General Director of KPM and Mr Stejar, the Deputy Manger General Finance of KPM and TNG were interviewed by the Financial Police as potential “entrepreneurs” under section 190(2)(b) of the Criminal Code of the Republic of Kazakhstan (**Exhibit R-58**).
- 26.22 Fourthly, a search for the information requested was carried out on 30 December 2008. This search was conducted in full compliance with the Kazakh law.
- 26.23 Fifthly, in early May 2009, the Financial Police sent copies of KPM’s account ledgers for 2005 and 2006 to the Regional Scientific and Production Laboratory of Forensic Examination in Astana to consider the correct calculations of revenues by KPM. Based on previous reports dated 28 November (No 2262/1 and 0690 carried out on 7 April 2009) the Financial Police requested that the expert assess whether, in its view, the value of income from illegally operating the trunk pipeline amounted to 21,673,919,031 tenge within the relevant period (7 March 2007 to May 2008) when Mr Cornegruta was the General Director of KPM. The expert concluded the following (among others things):
- (a) KPM’s income from carrying out unlicensed activity from April 2002 to 2008 comprised a total of 65,479,414, 917 tenge.
 - (b) KPM’s income during the relevant period in 2007 and 2008 comprised 21,673,919,031 tenge (**Exhibit C-184**).
- Given this, it is denied that the expert calculated the “illegal profits” from oil and gas transportation services at 5.9 million tenge for the period from 2002 to 2008 asserted by the Claimants in paragraph 92 of the Statement of Claim.
- 26.24 Sixthly, on 17 June 2009, the Financial Police announced publicly that the investigative phase had been concluded (**Exhibit C-118**) and on 23 June 2009, the Financial Police submitted the whole case to the Public Prosecutor of the Western Regional Transport for consideration (**Exhibit C-183**).
- 26.25 Lastly, and in accordance with the due process demonstrated by the Republic throughout the pre-trial investigation, the relevant authorities dealt with the complaints raised by the Claimants regarding the actions of the Financial Police and referred to at paragraph 96 of the Statement of Claim. Accordingly:

- (a) As the Claimants assert at paragraph 96 of the Statement of Claim, on 19 January 2009 KPM and TNG contacted 5 separate authorities with complaints as to the “illegal” actions of the Financial Police in its investigations.
- (b) As to the response to the Claimants’ further complaint on 18 March 2009 (in respect of which no evidence has been presented), the Claimants are put to proof that this was not adequately and properly dealt with by the explanation that the criminal proceedings might be suspended.
- (c) As to the complaint that the Republic failed to respond to requests by Mr Stati to the President to deal with the problems allegedly faced by TNG and KPM at a high-level, it is surprising that the Claimants omit to refer here to the meeting of 19 March 2009 that they later refer to at paragraphs 106 and 150. As the draft meeting minutes show (**Exhibit C-111**) this meeting dealt with all the substantive issues complained of by KPM and TNG at this stage. This meeting is discussed fully at 13.47(e)(v).

26.26 Against this context, the Claimants’ allegations are utterly wrong footed and rely on a frankly untenable ignorance of the legal environment in which they were investing:

- (a) There was no “*dogged pursuit*” by the Financial Police. Rather, the Financial Police carried out pre-trial investigation in accordance with due process in order to collate together and check their reasonable suspicions that Mr Cornegruta and others were guilty of illegal entrepreneurship.
- (b) In relation to the calculation of “illegal profits”:
 - (i) It is simply incorrect to assert, as the Claimants do in paragraph 93 of the Statement of Claim, that “*large amounts of illegal profits are required to transform what would otherwise be an administrative complaint into a fully-fledged criminal prosecution*”. It is illegal to hold a trunk pipeline without a licence. Such circumstances validly give rise to the prospect of prosecution and, if the charges are found to be well-founded, the consequences are severe. The legislation simply provides that the more egregious the criminal’s defrauding of the Republic, the stricter the penalty.
 - (ii) The Republic’s assessment of the illegal income accrued by KPM and TNG as a result of the illegal entrepreneurship was neither “*exceedingly crude*” (SoC 92) or “*ridiculous*” (SoC 93). The Tax Committee’s assessment of TNG’s revenues was based on its own tax filings and that of KPM was based on the analysis of the primary underlying material. The legislation requires the assessment of all revenue or income accrued illegally, not “*profits*” as alleged by the Claimants. This is logical since the legislation aims to return funds illegally procured to the State. The internal machinations of a company (how it allocates its profits and loss, how much it

chooses to spend on operating expenditures) are of no significance to the State. Accordingly, it is incorrect to allege, as the Claimants do, that the taxes paid (if any) or operating expenses of a company should be deducted. Accordingly, both the methodology of the Tax Committee's calculation and the calculation itself were carried out correctly.

- (iii) Moreover, as discussed further at Section 27 in relation to KPM, the court of Aktau found Mr Cornegruta guilty of illegal entrepreneurship on 18 September 2009 and affirmed, based on the decision of the expert given in May 2009 (**Exhibit C-117**), that the amount of illegal income owing by KPM was 21, 673,919,031 tenge. This decision was further confirmed on appeal in November 2009 as the Claimants acknowledge at paragraph 120 of the Statement of Case. As such, given that the decision was scrutinised fully in the Kazakh courts, this is not a decision that requires further scrutiny by any other tribunal / authority.
- (c) It is not admitted that on 15 May 2009 the Financial Police notified KPM and TNG that it had seized KPM's and TNG's equity interests on 13 May 2009 and the Claimants are put to proof that such notification was given or that such seizure took place as asserted in paragraph 121 of the Statement of Claim. That said, if the allegation is that KPM and TNG were prevented from selling or transferring their interests "*during the proceedings against Mr Cornegruta*", such a move would seem entirely appropriate in the circumstances. As the Claimants admit, the assets "*could otherwise be used in normal business operations*" and if the Financial Police moved to gain interim measures of security over KPM and TNG pending the resolution of a bona fide underlying dispute, this would not be surprising.

27 Arrest of Mr Cornegruta and trial of KPM

THE REPUBLIC'S ANALYSIS

Main point of the Claimants' statement

- 27.1 The Statement of Claim (in particular in paragraphs 107-123) contains information about criminal prosecution which allegedly became a part of indirect expropriation of the Claimant's Investments.
- 27.2 The Claimant draws attention to the following facts which, in the opinion of the Claimant, are illegal and indicative of indirect expropriation:
 - (a) General Director of "Kazpolmunay" LLP Mr. Sergey Cornegruta, was arrested by the Financial Police on April 25, 2009 on the charge of illegal entrepreneurial activity under

Article 190(2)(b) of the Criminal Code of the Republic of Kazakhstan for owning and operating a trunk pipeline without a license.

- (b) Mr. Cornegruta's trial lasted from July 30 until September 18, 2009.
- (c) Arguments of the defence were reduced to the following: the pipeline concerned was not a trunk pipeline and Mr Cornegruta was not a businessman and could not be held liable under Article 190 of the Criminal Code of the Republic of Kazakhstan "Illegal Entrepreneurship".
- (d) The prosecution submitted the confession of Mr. Cornegruta, and namely the letter Mr. Cornegruta had written on June 13, 2008 to the Agency of the Republic of Kazakhstan for Regulation of Natural Monopolies. Mr. Cornegruta's counsel argued that his June 13, 2008 letter was not even remotely a "confession," and that the "Kazpolmunay" gathering system did not include "trunk" pipelines.
- (e) As the key argument of his defence the counsel for the defendant stated that Mr. Cornegruta was not an entrepreneur, that he was an employee of "Kazpolmunay", that he did not own "Kazpolmunay", and that his June 13, 2008 letter was not even remotely a "confession," and that the "Kazpolmunay" gathering system did not include "trunk" pipelines.
- (f) On September 18, 2009, the Aktau City Court rendered a guilty verdict against Mr. Cornegruta. The verdict stated that the accused "was illegally engaged in entrepreneurial activities by operating the "trunk" pipeline of "Kazpolmunay" without a license". Mr. Cornegruta was sentenced to four years in prison. Mr. The convicted filed an appeal of his verdict with the Mangystau Regional Court. On 12 November 2009, the Mangystau Regional Court affirmed the verdicts of the Aktau City Court.
- (g) Despite the fact that "Kazpolmunay" was not criminally indicted, named, made a party, present in court, or represented at the trial of Mr. Cornegruta, and despite the fact that the State had not brought a civil action against "Kazpolmunay", the Aktau City Court also rendered a verdict against "Kazpolmunay", ordering it to pay the Government of the Republic of Kazakhstan a fine of approximately USD 145 million. This sum constituted all of oil and gas production revenues of "Kazpolmunay" from March 2007 to May 2008 (the period of time when Mr. Cornegruta held the office of General Director of "Kazpolmunay").
- (h) Besides the Claimant especially underlines the fact that in the period from 16:20 on 06 May 2007 till 04:15 on 07 May 2007 the Financial Police searched the offices of the companies «Kazpolmunay» and «Tolkynneftegaz» for the purpose of establishing of location of the rest two General Directors of "Kazpolmunay" (who held that office earlier)

– Mr. Salagor and Mr. Spasov, as well as general Director of “Tolkynneftegaz” Mr. Kozhin. These persons were accused of the same crime as Mr. Cornegruta. Further, the apartment of Mr. Cornegruta was searched. The Claimant presents these searches as a flagrant violation of its rights.

Content of the crime committed by Mr. Cornegruta

- 27.3 The crime committed by Mr. Cornegruta is the conduct of entrepreneurial activity without a license (**Exhibit R-139**).
- 27.4 Article 190 of the Criminal Code of the Republic of Kazakhstan (disposition of parts 1) sets forth the following:
- “1. Carrying out of entrepreneurial activity without registration or **without a special permit (license)** in cases where such permit (license) is obligatory or with violation of the licensing requirement, as well as engagement in prohibited types of entrepreneurial, if such acts have caused large-scale damage to an individual, organization, or the State, or are associated with profit-making on a large scale, or production, storage, transportation or marketing of excise goods to a considerable extent -- ...”* (**Exhibit R-58**).
- 27.5 As was already shown (paragraph 8 of the Statement of Defence) “Kazpolmunay” LLP indeed operated the trunk pipeline without a license.¹³⁴ This fact was acknowledged by General Director of “Kazpolmunay” LLP Mr. Cornegruta (**Exhibit C-115**).
- 27.6 It should also be taken into account that over the whole period of activity of the company “Kazpolmunay” from the moment of acquisition of 62% of its shares by the Claimant the company carried out the activity for subsoil use in the territory of the Republic of Kazakhstan without a duly executed license. So that Mr. Cornegruta could have been brought to criminal responsibility for his unlicensed activity in the sphere of subsoil use too.
- 27.7 To what extent was the arrest of Mr. Cornegruta legal and justified as a measure of restraint?
- 27.8 The Kazakh legislation admits the possibility to arrest the persons accused of a criminal offence. In particular, it is possible in that case if there are grounds to believe that such person may escape. Arrest of Mr. Cornegruta was explained exactly by this fact.
- 27.9 As Rakhimov Arman (Deputy Head of the Department for Economic and Corruption-Related Crimes (Financial Police for the Mangystau Region) noted: *“In respect of S. Cornegruta a measure of restrain was selected in accordance with the requirement of paragraph. 1 part 1*

¹³⁴ The same was done by “Tolkynneftegaz” LLP in respect of the condensate pipeline. At the same time no questions arise in respect of TOO “Tolkynneftegaz”, since General Director of this company hid from responsibility.

*article 150 of the Criminal Procedure code of the RK, which is authorized by the court due to the fact that he is a citizen of a foreign state and has no permanent place of residence in Kazakhstan, in which connection he may hide from the investigation and court” (see witness statement of Rakhimov Arman (**Exhibit R-138**)).*

The question of whether General Director of a legal entity can be brought to criminal responsibility under article 190 of the Criminal Code of the Republic of Kazakhstan

27.10 Definition of entrepreneurship in the law of Kazakhstan

- (a) In line with paragraph 1 Article 10 of the CC RK “Entrepreneurship is the activity of citizens and legal entities, taken on the initiative, irrespective of the form of ownership, which is aimed at the earning of net income by way of satisfying the demand for goods (work, services) which is based on the private property right (private entrepreneurship) or the right of economic management or operative administration of a state-owned enterprise (state entrepreneurship). Entrepreneurial activity shall be carried out on behalf of, under the risk, and under the property liability of the entrepreneur” (**Exhibit R-8**).
- (b) We would like to draw the attention that in accordance with the mentioned provision the entrepreneurship may be carried out both by natural and legal persons.
- (c) At the same time one should distinguish entrepreneurial activity of natural persons (individual businessmen) from entrepreneurial activity of legal entities. In accordance with Article 19 of the CC RK under individual entrepreneurs are meant citizens who have the right to engage in entrepreneurial activities without creating legal entities (**Exhibit R-8**).

27.11 Perpetrator of the crime under Article 190 of the Criminal Code of the Republic of Kazakhstan

- (a) Article 190 of the Criminal Code of the Republic of Kazakhstan is entitled “Illegal enterprise” (**Exhibit R-58**).
- (b) Hence, taking into account the definition of the term “enterprise” in force in the Kazakh legislation it may be concluded that basing on the title of Article 190 of the Criminal Code of the Republic of Kazakhstan an illegal enterprise of both natural and legal persons is concerned.
- (c) This Article is indicative of the fact that there is a “quasi-criminal” responsibility of legal entities in the Republic of Kazakhstan (just like in the Russian Federation).

27.12 Substance of “quasi-criminal” responsibility of legal entities in Kazakhstan

- (a) Substance of “quasi-criminal” responsibility of legal entities in Kazakhstan can be reduced to the following: in case if a legal entity is engaged in illegal entrepreneurial activity (for instance, carries out the licensed activity without a license) General Director

of the company shall be held responsible in form of deprivation of freedom. Moreover, if the sentence provides for the payment of money as penalties such amounts shall be recovered from a legal entity which in accordance with the legislation of the Republic of Kazakhstan bears the employer's liability for the harm caused to by an employee (see the Expert Opinion on Criminal Responsibility of G.S. Maulenov – **Exhibit R-140**).

27.13 Article 190 of the Criminal Code of the Republic of Kazakhstan (dispositions of parts 1 and 2) sets forth the following:

*“1. Carrying out of entrepreneurial activity without registration or **without a special permit (license)** in cases where such permit (license) is obligatory or with violation of the licensing requirement, as well as engagement in prohibited types of entrepreneurial, if such acts have caused large-scale damage to an individual, organization, or the State, or are associated with profit-making on a large scale, or production, storage, transportation or marketing of excise goods to a considerable extent -- ...*

2. The same acts:

a) committed by an organized group;

б) associated with profit-gaining on the especially large scale;

в) committed repeatedly, – ...”¹³⁵.

27.14 Similar to this provision in the Russian law the elements of the crime of a criminally punishable illegal enterprise are provided for in Article 171 of the Criminal Code of the Russian Federation (hereinafter – CC RF) (which is entitled similar to Article 190 of the Criminal Code of the Republic of Kazakhstan “Illegal enterprise”).

27.15 Article 171 of the CC RF (dispositions of parts 1 and 2) reads as follows:

*Carrying out of entrepreneurial activity without registration or with violation of the rules for registration, as well as submission to the body carrying out the state registration of legal entities and individual entrepreneurs, documents containing knowingly false information or **the conduct of entrepreneurial activity without a license**, in cases where such license is obligatory, if this act has caused large-scale damage to individuals, organizations, or the State, or is associated with profit-making on a large scale, - ...*

2. The same act:

a) committed by an organized group;

b) associated with profit-gaining on the especially large scale,-...¹³⁶.

27.16 In respect of determination of a perpetrator of the crime provided for by Article 171 of the CC RF the Plenum of the Supreme Court of the Russian Federation noted in paragraph 10 of its Resolution № 23 dated 18 November 2004 “Concerning judicial practice in the matters of illegal enterprise and legalization (laundering) of money or other illegally acquired property” the following:

“By implication of law as perpetrator of the crime provided for by Article 171 of the CC RF may act both a person having a status of individual entrepreneur and a person carrying out entrepreneurial activity without state registration as individual entrepreneur”.

If an organization (irrespective of a form of ownership) carries out illegal entrepreneurial activity the liability under Article 171 of the CC RF will be imposed on a person which by virtue of its official position permanently, provisionally or by virtue of special powers was vested with the functions for management of the organization (for example, head of the executive body of a legal entity or any other person authorized to act without proxy on behalf of this legal entity), as well as a person actually performing the functions of the organization’s head” (Exhibit R-142).

27.17 Thus, a perpetrator of the crime provided for in Article 171 of the CC RF can be General Director of a legal entity carrying out illegal entrepreneurial activity.

27.18 Taking into account similar dispositions of Article 171 of the CC RF and Article 190 of the Criminal Code of the Republic of Kazakhstan the Kazakh practice is also guided by a similar approach when determining a perpetrator of the crime provided for by Article 190 of the Criminal Code of the Republic of Kazakhstan.

27.19 The letter of the General Prosecutor’s Office of the Republic of Kazakhstan (**Exhibit R-143**) provides the statistics of criminal prosecution of directors of legal entities under Article 190 of the Criminal Code of the Republic of Kazakhstan. Thus, in 2008 22 heads of legal entities were convicted under this article.

27.20 In this connection in case of pecuniary sanctions these sanctions shall be paid by the company.

¹³⁵ See Exhibit R-58

¹³⁶ See Exhibit R-141.

- 27.21 The company “Kazpolmunay” was sentenced to payment in favour of the state of the sum in the amount of 21 685 854 578 Tenge (in accordance with paragraph. 19 of the Normative Ruling of the Supreme Court of the RK dated 18 June 2004).
- 27.22 In accordance with paragraph 19 of the Normative Ruling of the Supreme Court of the RK dated 18 June 2004 (**Exhibit R-144**), the entire revenue received as a result of perpetration of the crime shall be recovered from the guilty person to the treasury.
- 27.23 Search
- (a) The Claimant puts special emphasis on the fact that the Financial Police has searched the office and the apartment of Mr. Cornegruta. The Claimant presents this search as a flagrant violation of its rights. In fact, all searches were conducted in full compliance with the Kazakh legislation which is evidenced by the absence of any complaints in connection with the performed procedure of search, as well as by witness statements of the persons which carried them out (see **Exhibit R-138**).
 - (b) The Claimant could file an appeal against the actions of the Financial Police of the RK, however it did not do so.
 - (c) In particular, Rakhimov Arman noted that *“according to the Criminal Procedure Code of the Republic of Kazakhstan incident cite examination, seizure, search, etc. are aimed at gathering, examination and assessment of the evidence for the purpose of establishing the circumstances which are of importance for a substantiated and fair resolution of the case”, “no complaints against the actions and decisions of investigators in the course of the search were received” (Exhibit R -138).*

FURTHER ANALYSIS

- 27.24 At SoC 107 to 114 the Claimants assert that the arrest and detention of the General Manager of KPM, Mr Cornegruta, on a charge of illegal entrepreneurial activity, in relation to KPM's unlicensed exploitation of a trunk pipeline, was an act of victimisation by the Republic. They complain that Mr Cornegruta could not possibly have been guilty of the offence since he is a mere employee of KPM rather than its owner and was not registered as an entrepreneur in his personal capacity.
- 27.25 The Claimants also complain of a series of “raids” by the Financial Police and seek to portray the Financial Police's attempts to discover the whereabouts of senior members of TNG as being somehow indicative of some sort of personal war being waged against KPM and TNG.
- 27.26 As the Republic explains below, in reality:

- (a) The senior managers of Limited Liability Partnerships such as KPM and TNG are liable to prosecution for crimes committed by the entities that they operate.
- (b) As such the arrest of Mr Cornegruta in connection with KPM's wrongdoing was lawful and the senior managers of TNG were also the proper focus of the Financial Police's attention in connection with the criminal activities of TNG.
- (c) Furthermore, the Financial Police are entitled refuse to grant bail to individuals charged with criminal offences that they suspect may seek to avoid responsibility for their acts by leaving Kazakhstan.

27.27 In any event, the Claimants have failed to adequately demonstrate that the arrest of and trial of Mr Cornegruta adversely affected the alleged investments.

Illegal Entrepreneurial Activity and criminal responsibility of legal entities

27.28 Under Article 10 of the Civil Code of the Republic of Kazakhstan (**Exhibit R-8**) "entrepreneurship" is defined as:

"initiative activity of citizens and legal persons, independently of the type of ownership, aimed at net profit gaining through satisfaction of demand on goods (works, services) based in the right of private ownership (private entrepreneurship) or on the right of economic management or operating management of state-owned enterprise (state entrepreneurship). Entrepreneurial activity is exercised on behalf, for risk and under the property responsibility of an entrepreneur".

27.29 As such, both individuals and legal entities (such as KPM and TNG) can be entrepreneurs. Further, individuals carrying out entrepreneurial activity by operating via legal entities can be entrepreneurs.

27.30 Pursuant to Article 190 of Criminal Code the crime of illegal entrepreneurial activity is defined as follows:

*"The exercise of illegal entrepreneurial activity without registration or **without a special permit (Licence)** in cases in which a permit (licence) is obligatory, or in violation of terms of licensing, as well as engagement in prohibited types of entrepreneurial activity, if these acts caused a considerable damage to a citizen, organisation, or the state, or if these acts are combined with the receipt of profit in a large amount or production, storage or marketing of excisable goods in material quantities" ¹³⁷*

¹³⁷ Exhibit R-58

- 27.31 Where illegal entrepreneurial activity is carried out by a legal entity, liability is shared between the legal entity and its General Manager under the doctrine of “quasi criminal responsibility”.
- 27.32 The substance of “quasi-criminal” responsibility of legal entities in Kazakhstan can be reduced to the following: if a legal entity is engaged in illegal entrepreneurial activity (for instance, carries out the licensed activity without a license) the General Director of the company shall be held responsible by way of any custodial sentence. If the sentence provides for the payment of money as penalties or for the recovery of sums accrued in the course of illegal activity, such amounts shall be recovered from the legal entity which, in accordance with the legislation of the Republic of Kazakhstan, bears the employer’s liability for the harm caused to by an employee (**Exhibit R-140**). As a matter of procedure, the General Manager is the Defendant in any criminal proceedings arising out of illegal entrepreneurial activity as the Claimants admit (SoC 114).
- 27.33 The letter of the General Prosecutor’s Office of the Republic of Kazakhstan (**Exhibit R-143**) provides the statistics of criminal prosecution of directors of legal entities under Article 190 of the Criminal Code of the Republic of Kazakhstan. Thus in 2008, 22 heads of legal entities were convicted under this article. Accordingly, there can be no suggestion that Mr Cornegruta was victimised in any way.

Components of the crime of illegal entrepreneurial activity

- 27.34 Article 4 of the Law “On Natural Monopolies” 1998 (**Exhibit R-127**) provides that the operation of a trunk pipeline for the transport for oil is considered to be a natural monopoly which is subject to a special licensing regime.
- 27.35 In accordance with the Law “On Licensing” 1995 (**Exhibit R-24**) a licence from the Ministry for Energy and Natural Resources (**MEMR**) was required to operate trunk oil or gas pipelines. In 2007 that licensing regime was altered by the Law “On Licensing” 2007. Holders of existing pipeline licences (for both trunk and other pipelines) were required to renew their licences with the Agency on Regulating Natural Monopolies (**ARNM**) under Article 12 of the Law “On Licensing” 2007.
- 27.36 It is apparently admitted by the Claimants that neither KPM nor TNG held licences from either the MEMR or the ARNM for the operation of a trunk pipeline (SoC 80). Therefore, if either company profited from the operation of a trunk pipeline it would constitute illegal entrepreneurial activity under Article 190 of the Criminal Code of the Republic of Kazakhstan.
- 27.37 In those circumstances, as described above, both KPM and TNG and their respective General Managers would bear responsibility for any criminal sanctions imposed as a result of such illegal entrepreneurial activity

Arrest of Mr Cornegruta

- 27.38 Mr Cornegruta was the General Manager of KPM and, as such the most senior executive of that company. As the Claimants relate, Mr Cornegruta was questioned by the Financial Police as a witness in its investigation of KPM's activities on 25 December 2008, shortly after the initiation of that investigation. Given Mr Cornegruta's position within KPM, his responsibility under law for any criminal activity of KPM, and the fact that Mr Cornegruta had made an application for a licence to operate a trunk pipeline on KPM's behalf (SoC115 and **Exhibit C-115**), it is perfectly natural that the Financial Police should have wanted to speak to Mr Cornegruta.
- 27.39 It is denied that Mr Cornegruta was not permitted to have his legal counsel in attendance for that interview. Witnesses, such as Mr Cornegruta are entitled to be accompanied by legal counsel during interviews under Article 82.3 of the Criminal Procedure Code of the Republic of Kazakhstan (**Exhibit R-35**).
- 27.40 Following the interview Mr Cornegruta was permitted to leave and to go about his business, including the operation of KPM freely. He was not arrested for another four months and after a thorough investigation of the situation concerning KPM's activities.
- 27.41 Mr Cornegruta's arrest was, therefore, no knee jerk reaction to the command of an authoritarian regime or reckless exercise of oppressive powers, as the Claimants would like to suggest. Rather it was the proper conclusion of a lawful investigation which concluded that KPM had committed illegal entrepreneurial activity. As a result Mr Cornegruta, the General Manager and hence controller of KPM's activities, was arrested and properly made the Defendant to the criminal proceedings relating to those activities.
- 27.42 As to SoC paragraph 107:
- (a) It is not apparent what significance the Claimants attach to the circumstances of Mr Cornegruta's arrest and no admission is made as to these.
 - (b) As for the somewhat hysterical assertion that Mr Cornegruta was subsequently "*interrogated*" it is completely normal for the Financial Police to question a suspect following their arrest.
- 27.43 As for SoC 108, the Claimants protest that Mr Cornegruta did not own KPM, that he was an employee of KPM and was not personally registered as an entrepreneur. No admission is made as to these matters. However, they are entirely irrelevant to the issue of Mr Cornegruta's responsibility as General Manager of KPM for the illegal acts of the company.
- 27.44 As to paragraph 109 of the SoC, no admission is made as to the reaction of Mr Cornegruta's colleagues and the local community, which are similarly irrelevant to the legality of his arrest in respect of the activities of KPM. As regards the complaint lodged against Inspector Rakhimov (**Exhibit C-113**) it is denied that there was any basis for complaint against the conduct of Inspector Rakhimov, who had simply performed his duties in accordance with the relevant laws.

27.45 As to paragraph 110 of the SoC, It is admitted that Mr Cornegruta was denied bail. Under Article 150.1.1 of the Criminal Procedure Code of the Republic of Kazakhstan (**Exhibit R-35**), a suspect may be denied bail where there are reasonable grounds to consider that the suspect will attempt to escape the jurisdiction of the Kazakh courts. As the explanation of the Office of the General Prosecutor of the Republic of Kazakhstan sets out, those grounds existed in the case of Mr Cornegruta (**Exhibit R-139**), who is of Moldovan nationality (SoC 332 8th bullet point) and in possession of a Schengen Visa, which would enable him to leave Kazakhstan and Moldovan authorities will not arrest its citizens for the purpose of extradition (Cojin para 24). Indeed, the General Manager of TNG, which was also under investigation, failed to return to Kazakhstan after learning of the arrest of Mr Cornegruta (Cojin para 20 to 22).

27.46 The position is confirmed in the statement of Rakhimov Arman (Deputy Head of the Department for Economic and Corruption Related Crimes (Financial Police for the Mangystau Region)) and the Clarification given by Kravchenko A.A. (Deputy Prosecutor General of the Republic of Kazakhstan):

“In respect of S Cornegruta a measure of restraint was selected in accordance with the requirement of Para 1 Article 150 of the Criminal Procedure Code of the RK, which is authorized by the court due to the fact that he is a citizen of a foreign state and has no permanent place of residence in Kazakhstan, in which connection he may hide from the investigation and court” (**Exhibit R-138 and R-139**)

27.47 At to paragraph 111 of the SoC,

- (a) it is admitted that the Financial Police searched the premises of KPM and TNG, which are located in the same building. The search was carried out, pursuant to a warrant dated 30 April 2009, in accordance with the relevant provisions of the Criminal Procedure Code and in the presence of the Deputy Director General for Economic and Financial Affairs of TNG, Mr Stejar (**Exhibit C-114**).
- (b) It is further admitted that details were obtained relating to Mr Cojin, Mr Salagor and Mr Spasov. Since TNG was also under investigation for illegal entrepreneurial activities and Mr Cojin, Mr Salagor and Mr Spasov each held the position of General Manager of those companies, it was entirely legitimate that the Financial Police should want to understand their whereabouts.
- (c) It is denied that the conduct of the Financial Police was intended to cause distress to or to intimidate the employees of KPM and TNG and it is not admitted that any of them were distressed or felt intimidated. In any event all officers of the Financial Police participating in the search acted reasonably and within the bounds of the law.

27.48 As to SoC 112 it is admitted that the Financial Police searched the locations and recovered the documents referred to in the minutes of the search (**Exhibit C-114**). Otherwise no admission is made as to SoC 112. The Republic notes that despite the Claimants' suggestion that these searches were in some way a breach of the rights of those concerned, no complaints were made at the time as confirmed by the Clarification given by Kravchenko A.N. (Deputy Prosecutor General for Mangystau Region):

“according to the Criminal Procedure Code of the Republic of Kazakhstan incident cite examination, seizure, search etc. are aimed at gathering examination and assessment of the evidence for the purpose of establishing the circumstances which are of importance for a substantiated and fair resolution of the case”, “no complaints against the actions and decisions of investigators in the course of the search were received” (Exhibit R-139)

27.49 As to SoC 113 no admission is made as to whether any such letter was written or sent to or received by President Nazarbayev. In any event it is denied that President Nazarbayev would have any obligation to respond to any such letter considering, in particular, the lack of any grounds for the allegations allegedly made by Mr Stati and the lawfulness of the activities of state bodies, which the Claimants suggest underlie those allegations.

Trial of KPM

27.50 As noted at paragraph 27.31 to 27.33 above, Mr Cornegruta was correctly named as Defendant in the proceedings arising out of KPM's criminal activities. It is therefore inaccurate the say that the trial was of Mr Cornegruta. Strictly it was the trial of KPM, at which Mr Cornegruta was its representative.

27.51 The Claimants' principal complaints concerning the trial (**paragraphs 107 to 120 of the SoC**) are:

- (a) The licence application made by Mr Cornegruta on KPM's behalf for operation of trunk gas and oil pipelines was some sort of administrative mistake and not a “confession” as the Claimants say it was treated by the prosecutor.
- (b) Mr Cornegruta was not an entrepreneur;
- (c) The court based its verdict as to the classification of KPM's pipeline as a trunk pipeline on the prosecution's evidence alone and ignored KPM's evidence to the contrary;
- (d) Mr Cornegruta's sentence was in any event excessive; and
- (e) The court imposed a fine on KPM when it was not a party to the proceedings.

- 27.52 On the basis of these complaints, the Claimants label the trial as a further example of the Republic's indirect expropriation of the Claimants' investments as well as breaches of other provisions of the ECT.
- 27.53 The Republic's position is that the trial was properly conducted in accordance with due process, that KPM was properly convicted of illegal entrepreneurial activity and that the sentences of Mr Cornegruta also accorded with the relevant laws.
- 27.54 As to paragraph 114 of the SoC it is admitted that criminal proceedings against KPM and TNG would be properly brought in the name of the General Manager of those companies. If KPM, Mr Cornegruta and/or Mr Cornegruta's representative failed to appreciate that Mr Cornegruta was a party to the criminal proceedings as a result of the conduct of KPM and that KPM was, in effect represented by Mr Cornegruta, that does not mean that no opportunity was provided for KPM to be defended against the allegations made against it. Accordingly any such allegation is denied. Otherwise no admission is made.
- 27.55 As to paragraphs 115 to 116 of the SoC it is denied, if alleged, that the court was wrong to take into account, as supportive of its decision that KPM had operated a trunk pipeline, the licence application made by Mr Cornegruta on behalf of KPM to ARNM dated 13 June 2008 (**Exhibit C-116**) for permission to carry out activities including operation of trunk gas and oil pipelines, for the following reasons:
- (a) The Claimants admit that Mr Cornegruta wrote the letter of 13 June 2008 (paragraph 115 of the SoC);
 - (b) The letter clearly requests a licence:

"For the following subtypes of activities:

 - *Use of oil and oil products storages (oil and gas storage, tank farms, tankers);*
 - *Use of equipments, the pumping-compression plants facilities, of the tank farms and of the linear sector on the **main gas and oil products pipelines**, as well as the technological equipment"*
 - (c) The Claimants suggest that Mr Cornegruta unthinkingly wrote down every activity covered by Article 12 of the Law "On Licensing" 2008 (**Exhibit R-24**) in a "laundry list" and was merely careless to include "*main gas and oil products pipelines*" amongst them. However the evidence suggests the opposite; that Mr Cornegruta made a conscious selection of activities including "*main gas and oil products pipelines*" because:

- (i) The letter does not in fact refer to all activities listed in Article 12 of the Law “On Licensing” 2008 (**Exhibit C-116**), which also refers to “underground gas storage wells”, which are not operated by KPM and are not included in the letter.
 - (ii) KPM undertakes every other activity referred to in the letter as part of its operations.
- (d) The Claimants argue that an alleged reference to the words “*production sector*” in Mr Cornegruta’s letter mean that the subsequent reference to “*main gas and oil products pipelines*” should be discounted. However:
- (i) There is no reference in the letter to the words “*production sector*”. Therefore Mr Cornegruta did not attempt to qualify his request in this manner; and
 - (ii) In any event in Article 12 of the Law “On Licensing” 2008, (**Exhibit R-24**) the operation of “*main gas and oil products pipelines*” is included as part of a list of “*production activities*”, suggesting that even if Mr Cornegruta had included such wording in his letter, it would not have qualified the reference to “*main gas and oil products pipelines*” as the claimants suggest.

27.56 In conclusion therefore, the evidence suggests that Mr Cornegruta deliberately excluded certain activities from his licence application and deliberately included others, including operation of “*main gas and oil products pipelines*”. Accordingly the court was quite correct to refer to Mr Cornegruta’s letter of 13 June 2008 as supportive of its decision that KPM operated a trunk pipeline.

Mr Cornegruta is not an entrepreneur

27.57 As to paragraph 117 of the SoC:

- (a) It is denied if alleged that the issue of whether Mr Cornegruta is an entrepreneur in his personal capacity was relevant to the court’s decision. KPM, Mr Cornegruta and the Claimants appear to misapprehend the fact that:
 - (i) as described at paragraph 27.28 above, under Article 10 of the CC RK both individuals and legal entitles can be an entrepreneur; and it was KPM that was accused; and
 - (ii) Mr Cornegruta, as General Manager, was effectively the representative of KPM and was not accused of illegal entrepreneurial activity in his personal capacity.
- (b) In relation to Mr Cornegruta’s letter of 13 June 2008, the Republic repeats paragraphs 25.1 to 25.4 and 27.55.
- (c) In relation to the KPM’s so called expert opinions:

- (i) It is denied that the opinions other than that of Mr Suleymenov were given by consultants qualified to give **expert** evidence as to whether KPM's pipelines were trunk pipelines for the reasons given at paragraphs 28 below.
 - (ii) It is not admitted that there were seven opinions, expert or otherwise. The Claimants refer to SoC section IV.B.3 in support of this contention. However, only five consultants are referred to there.
 - (iii) It is denied that the Financial Police threatened any of KPM's experts. The Claimants adduce no evidence of such behaviour. The Financial Police did write to the MES (**Exhibit C-92**) in relation to letters and reports it had issued at KPM and TNG's request (**Exhibit C-90, C-91, C-102 and C-103**), pointing out that the question of whether KPM and TNG's pipelines were trunk pipelines were out of its competency. That was acknowledged by the Deputy Minister of the MES in his letter of 30 April 2009 (**Exhibit R-189**) and the letters and opinions were subsequently withdrawn.
- (d) It is admitted that the prosecutor relied upon a single opinion dated 13 February 2009.
- (e) As recorded in the decision of Judge Raskalieva KJ (**Exhibit C-115**), much of KPM's evidence concerning the status of its pipeline was found to be inadmissible as follows:
- (i) KPM did not object to the Financial Police's argument that the following evidence was inadmissible:
 - (A) Explanation of the Department of CS Mangystau region of 19 November 2008
 - (B) DGP survey report of the scientific research centre for technological safety of oil and gas industry oil and gas geology RGP National Centre of scientific research on industrial safety issues ERM Republic of Kazakhstan, exit number 07 of January 8, 2009;
 - (C) Explanations of the joint stock company "Institute for scientific research and institute of oil and gas design" of January 9, 2009;
 - (D) Experts report of the joint stock company "Kazakh Institute for scientific research and oil and gas design" of January 5, 2009, no 005/08-2.
 - (ii) As noted in the decision, Article 311, Part 1 of the Criminal Procedure Code of the Republic of Kazakhstan (**CPC**) (**Exhibit R-35**)

"in the judicial debate all the evidence in the record must be investigated directly"

- (iii) The author of the evidence must attend and be examined on his evidence. However, as noted by Judge Raskalieva KJ:

“The authors of the above records were invited to the hearing to examine their conclusions, but witnesses were not present at trial, and therefore the source of the documents could not be established and they cannot be accepted as evidence”

- (f) Other such evidence presented by KPM was considered by the court, but found to be unpersuasive including testimonies of:

“Nurlibekov G, Nazaraliev S, Marun Yu, Indreisov M and others heard during the proceedings who confirmed that the TPPN pipeline to the BTS, station Opornaia was not the main one.”

- (g) The court also considered the technical evidence presented by the prosecution which was supportive of the claim that KPM’s pipe was a trunk pipeline and, as Judge Raskalieva KJ notes:

“Experts conclusions are reasonable and legal, and consistent with the other evidence in the record”

- (h) Unsurprisingly, the Claimants are silent as to the above facts concerning evidence before the court at KPM’s trial. However it is notable that the Claimants do not assert that the court was wrong to treat the evidence in this manner. It is clear that the court gave due consideration to the evidence put forward by the Claimants and weighed it against that presented by the prosecution before concluding that KPM’s pipeline was a trunk pipeline.

27.58 As to paragraph 118 of the SoC:

- (a) no admission is made as to the reaction of the Claimants or their employees. Otherwise the paragraph is admitted.
- (b) Article 190 of the Criminal Code of the Republic of Kazakhstan states that the maximum term of imprisonment applicable to the crime of illegal entrepreneurial activity is 5 years with the confiscation of property (**Exhibit R-58**).
- (c) In imposing a sentence of 4 years on Mr Cornegruta the court stated:

“Thus the court concludes that the defendant is proved guilty....being combined with obtaining an income amounting very high:

By setting the penalty the court sees no mitigating and aggravating circumstances of criminal liability and penalties

The defendant was not tried in the past and is characterised positively and has family” (Exhibit C-117)

- (d) Clearly therefore, the court gave due consideration to the relevant factors before imposing it sentence of 4 years imprisonment and confiscation of property, which is well within the range of sentences that the court is entitled to consider. There can be no suggestion therefore that the sentence was arbitrary or intended to victimise Mr Cornegruta, KPM or the Claimants.

27.59 As to paragraph 119 of the SoC:

- (a) It is denied that KPM was not criminally indicted. The Republic repeats paragraph [x] [X-ref to the paragraphs regarding Cornegruta being named defendant representing KPM]
- (b) It is admitted that no civil action had been brought against KPM. However its relevance to the lawfulness of the imposition of a fine on KPM (if alleged) is denied.
- (c) It is admitted that KPM was ordered to pay 21,675,854,578 Tenge, based on the assessment of the income received by KPM as a result of its illegal entrepreneurial activity dated 18 May 2009 (Exhibit C-117 and C-184).
- (d) In accordance with Article 921 of the Civil Code of the Republic of Kazakhstan (Exhibit R-8) a company is liable for the harm caused by its employees in performance of their work. The General Manager is an employee of the company.

According to Article 19 of the Regulatory Resolution of the Supreme Court of the Republic of Kazakhstan of 18 June 2004, companies convicted of illegal entrepreneurial activity are liable for forfeit all monies gained during the period of such activities. (Exhibit R-144)

- (e) It is not admitted whether that sum constitutes all of KPM’s oil and gas production revenues from March 2007 to May 2008.
- (f) It is not admitted whether KPM had already paid taxes on such income. However, to the extent that taxes had been paid on that income it is apparent that KPM neglected to provide evidence of this to the court, which in considering this sum commented:

“no information being presents about the paid taxes, so the shown revenue must be directed for the state.” (Exhibit C-117)

- (g) It is not admitted whether the above sum bears any relationship to transportation fees earned by a trunk pipeline operator or whether such fees represent the sole income of such an operator. However, the relevance of these assertions to the computation of the sums KPM was obliged to pay is denied.

- (h) It is admitted that the Centre for Forensic Examination of the Ministry of Justice of the Republic of Kazakhstan issued a report dated 18 May 2009. Further, it is noted that the document was considered and relied upon by the court in determining the amount of the fine imposed on KPM. In all other respects the Claimants' assertions concerning this report are not admitted.

27.60 As to SoC paragraph 120

- (a) It is admitted that KPM was not a named party in either the initial trial or the subsequent appeal. However it is denied that KPM was not represented in either hearing. The Republic repeats paragraph 27.31 to 27.33 above.
- (b) The appeal against the conviction of KPM and the sentences imposed on Mr Cornegruta and KPM was unsuccessful.
- (c) The reaction of Mr Cornegruta's colleagues and family are not admitted.
- (d) Otherwise the paragraph is denied.

28 The Opinions of the Claimants' consultants are not relevant or accurate

28.1 The Claimants rely on opinions from 5 consultants in support of their assertion that KPM's pipeline was not a trunk pipeline:

- (a) Opinion of the Kazakh Scientific Research and Design Institute of Oil and Gas; (**C-99 and C-100**)
- (b) Scientific Research and Design Institute of Oil and Gas Industry of NIPI Neftegaz (**C-101 and C-102**);
- (c) National Scientific and Research Centre on Industrial Safety Issues of the Ministry of Emergency Situations of Kazakhstan (**MES**) (**C-103 and C-104**);
- (d) Russian Science and Research Institute for the Construction and Operation of Pipelines and Energy Facilities (**C-105 and C-107**); and
- (e) Mr Suleymenov, the Director of the Institute of Private Law of the Kazakh Law University of the National Academy of Science (**C-108**).

28.2 Notwithstanding that during the trial of KPM, the court properly found that KPM's pipeline was a trunk pipeline, such that the Arbitral Tribunal need not consider this matter afresh. As the Republic demonstrates below, the conclusions of the Claimants' consultants that KPM's pipeline was not a trunk pipeline were wrong.

- 28.3 As explained below, the first four of these consultants are not qualified to opine on the issue and the last consultant bases his conclusion on matters that are not determinative of whether a pipeline is a trunk pipeline or not.
- 28.4 In relation to consultants a, b, d, and e, their relationship with the Claimants is not apparent and the Claimants make no assertion that any of their views were independent or impartial. Indeed, since their opinions were apparently obtained for the purpose of defending Mr Cornegruta and KPM, the Arbitral Tribunal is entitled to assume that their opinions are neither independent nor impartial.
- 28.5 Whilst the Claimants assert that each opinion is an ‘expert’ opinion, since the question of whether a pipeline is trunk or not is a matter of law, only Mr Suleymenov may be regarded as having expertise in relation to the issue.
- 28.6 The expertise of consultants a, b, and d appears solely technical, as is apparent from their opinions (**Exhibit C-99, C-101, C-105**). As noted above, the technical specifications of a pipeline, including the standards to which it is designed and constructed are not determinative of the issue of whether it is a trunk pipeline. Indeed this is recognised in the report of Mr Suleymenov where he says:
- “The safety requirements for the operation of oil main lines and non-main ones, foreseen in separate CNaS, regulations etc. for oil-main pipelines and non-main ones, could coincide as these requirements are determined by the technical specifications that can be the same (physical-chemical parameters pipe diameters, acceptable pressure, needed engineering facilities, other technical decisions for the assurance of safe operation, and so on”*
- 28.7 Further as acknowledged by consultant d (**Exhibit C-107** p 3.), the technical characteristics of field and trunk pipelines may overlap due to the harmonization of the normative documents in force in relation to pipeline design. As such these documents cannot be determinative of the issue.
- 28.8 In the case of consultant c, the MES, it is entirely unclear why KPM and TNG approached the MES to opine on the question of whether their pipelines are trunk pipelines. According to Part 1 s1 and part 2 s13 of the Regulation on the Ministry of Emergency Situations of RoK (approved by the Government order of 28 October 2004) (**Exhibit R-46**) the principal functions of the MES are the formation and execution of state policy concerning:
- (a) prevention and resolution of emergency situations of natural and technical nature;
 - (b) industrial safety;

- (c) coordination of activities of central and local government bodies and research organisations in relation to the emergency situations of natural and technical nature; and
- (d) state supervision of fire and industrial safety.

28.9 Therefore, whilst it may be qualified to comment upon the health and safety requirements for operating a pipeline, it has no expertise in determining whether a pipeline conforms to the legal definition of trunk pipeline contained in the Law “On Petroleum” 1995.

28.10 KPM and TNG first made contact with the MES in relation to pipelines on 19 November 2008 as is apparent from letters of the same date sent by the MES to each of them (**Exhibit C-90 and C-91**). It is notable that the Claimants have not disclosed the letters of KPM and TNG, so neither the questions asked nor motive for asking them are known.

28.11 The letters from the Mangystau Regional department of the MES are relied upon by the Claimants as evidence that KPM and TNG’s pipelines were not trunk pipelines. In fact the letters say nothing of the sort. The text of each letter is materially identical and each concludes:

“Taking into account the aforementioned, all pipelines operated by your enterprise, from the place of extraction to the point of transferring the hydrocarbons to the oil and gas main pipelines are not main pipelines.”

28.12 The conclusion is of course entirely circular. In effect, it says no more than “some of your pipelines are not main pipelines” a fact which the Republic does not dispute. It does nothing to affect the Republic’s position that the trunk pipeline into which certain of KPM’s contractor pipelines transferred hydrocarbons was operated by KPM without a licence.

28.13 In any event the conclusions carried no weight since they were outside the competence of the MES. This was acknowledged by the Deputy Minister of the MES in his letter of 30 April 2009 (**Exhibit R-189**) in which he recommended to the Mangystau Regional department of the MES that the letters be withdrawn explaining:

“In accordance with article 45 of the Law of the RK On Normative Legal Acts, official interpretation of subordinate legal acts shall be given by official bodies or officials that issued these acts, and therefore it means that [MES] had no competence to interpret norms of the Law of the RK On Oil.

[the department’s] conclusion was issued in violation of approved charter of SS and it follows from this that [the department’s] conclusion is illegal and unlawful.

On the basis of abovementioned information the Ministry considers that you should withdraw current letters and conclusions as soon as possible.”

- 28.14 The Mangystau Regional department of the MES agreed and withdrew its letters on 13 May 2009, as the Claimants acknowledge (SoC 91). However, contrary to the Claimants assertion the withdrawal was not in response to the letter of the Financial Police dated 21 November 2009, though the points made in that letter are quite correct.
- 28.15 Turning to the reports, solicited from the Mangystau Regional department of the MES by KPM and TNG, these also outside the competence of the MES and were also withdrawn as a result of the letter of the Deputy Minister of the MES dated 30 April 2009 and for the same reason as the letters (**Exhibit R-189**). Accordingly the contents of the report are of no consequence whatsoever.
- 28.16 As for the report of Mr Suleymenov (**Exhibit C-108**), whilst it appears that he is legally qualified and has certainly approached the classification of KPM's pipeline from a legal standpoint, it is not apparent that he has particular expertise in the area of Subsoil law. Certainly he considers a number of irrelevant issues in the course of his report:
- (a) In relation to sections 1 and 2 of his report, whilst the Subsoil Contract and Subsoil Licence may refer to oil production and whilst the definition of that activity in Article 1(24) of the Law "On Petroleum" 1995 includes transportation, those facts do not determine the classification of the pipeline down which oil is transported.
 - (b) In relation to section 2 of this report, the permission in a Subsoil Licence to transport oil does not extend to transport in a trunk pipeline, which is a separately licensed activity requiring a special licence as confirmed by Article 4 of the Law "On Natural Monopolies" 1998, the Law "On Licensing" 1995 and more recently Article 12 of the Law "On Licensing" 2007. Further any such permission extends only to transport within the area of operation granted by that license. Accordingly it cannot extend to transport via a trunk pipeline, which by definition exists outside such a licence area (see para 14 Art 1 of the Law "On Petroleum" 1995 (**Exhibit R-23**)).
 - (c) In relation to section 3 of his report, the definition of trunk pipeline is contained in paragraph 17, Article 1 of the Law of the Republic of Kazakhstan "On Petroleum" 1995 - a item of preimary legislation, secondary legislation and regulations, such as the design and construction standards referred to in this section, and the intended purpose of those designing and constructing the pipeline, do not affect the application of the definition of trunk pipeline contained in that primarily legislation. If a pipeline conforms to the definition in the Law "On Petroleum" 1995, it is a trunk pipeline. Indeed this appears to be recognised in point 4 of the report where Mr Suleymenov states:

"The safety requirements for the operation of oil main lines and non-main ones, foreseen in separate CNaS, regulations etc. for oil-mail pipelines and non-main ones, could coincide as these requirements are determined by the technical

specifications that can be the same (physical-chemical parameters pipe diameters, acceptable pressure, needed engineering facilities, other technical decisions for the assurance of safe operation, and so on”

28.17 It is in Point 4 of his report that Mr Suleymenov gets closest to identifying the determining factor of a trunk pipeline, where he recognises that from examining the definition of trunk pipeline in the Law “On Petroleum” 1995:

“Two conclusions can be drawn from the technical definition of an oil main pipeline: 1) the oil main pipeline, being a type of oil pipeline, is an engineering construction and consists of a set of various premises; 2) the oil main pipeline is not a contractor’s pipeline since it is meant for the transport of oil from the contractor’s pipeline to the place of transfer to another means of transportation”

28.18 KPM’s pipeline is undoubtedly “an engineering construction consisting of various premises” and Mr Suleymenov does not appear to doubt this. Therefore, as noted at paragraph 23.15 above, it is the meaning of “contractor’s pipeline” that is determinative of whether KPM’s pipeline is a trunk pipeline. However Mr Suleymenov fails to register this essential point, which may explain his misguided attempts to determine the issue by a series of non-determinative factors in sections 1 to 3 of his report.

28.19 As described in paragraph 24 above, KPM’s pipeline was not a “contractor’s pipeline”, because it was outside the Contract Area of its Subsoil Contract as determined by its Subsoil Licence. Therefore it was a trunk pipeline.

28.20 The remaining points in section 4 of Mr Suleymenov’s report are no more compelling. The fact that the entrepreneurial activity of transporting oil in a trunk pipeline is heavily regulated in the Republic does not mean that Mr Cornegruta and KPM failed to heed those regulations. Indeed that was the point of the prosecution by the Financial Police. Finally, the boundaries of a single technological process, in the situation contemplated by Mr Suleymenov are determined by the boundary between the contractor’s pipeline and a trunk pipeline, rather than the other way round as he asserts.

28.21 In summary therefore

- (a) Four of the five opinions obtained by KPM in connection with the issue of whether KPM’s pipe line was a trunk pipeline were produced by consultants that were not qualified to express an opinion on the issue, because, despite any technical expertise they may have, the issue is a matter of law. Accordingly their opinions carry no weight whatsoever.
- (b) As regards KPM’s legal consultant, the majority of his reasoning is flawed as it relies on matters that are not determinative of the issue. Whilst in the final section of his report he

succeeded in defining the question posed by the definition of trunk pipeline in the Law “On Petroleum” 1995 - i.e. What is a “contractor’s pipeline”? - he fails to answer it.

29 Measures taken to enforce the KPM Fine

THE REPUBLIC’S POSITION

- 29.1 The Claimants did not carry out the decision of the court. The result of non-performance of the State’s requirements concerning payment of the charged amount was seizure of the property and enforcement measures.
- 29.2 On 30 April and 15 May 2009 the Financial Police issued attachment orders in respect of the contracts for subsoil use of “Kazpolmunay” LLP and TOO “Tolkynneftegaz”, pipelines and transport vehicles.
- 29.3 At the beginning of 2010 bankruptcy proceedings against “Kazpolmunay” LLP were initiated.
- 29.4 Enforcement measures result directly from KPM’s legal responsibility, since they are the measures which secure its realization in case of refusal of KPM’s to voluntarily comply. All enforcement measures carried out in relation to the companies “Kazpolmunay” and “Tolkynneftegaz” corresponded with the legislation of the Republic of Kazakhstan on enforcement proceedings (**Exhibit R-145**).

FURTHER ANALYSIS

- 29.5 Mr Cornegruta was found guilty of illegal entrepreneurship on 18 September 2009 a decision which was confirmed on appeal in November 2009 as acknowledged by the Claimants at paragraph 120 of the Statement of Claim. As set out above, the Aktau City Court and the Mangystau Regional Court that of KPM had improperly accrued 21,673, 919,031 tenge of income that should be retrieved to the Republic. KPM ignored the Republic's order for payment.
- 29.6 At paragraphs 124 to 139 to the Statement of Claim, the Claimants list a number of enforcement measures that the Republic was forced to take due to the fact that the KPM failed to repay the amounts due to the Republic, as ordered by the Aktau City Court and affirmed by the Mangystau Regional Court.
- 29.7 The Republic's attempts to recover the money illegally accrued by KPM took place as follows:
- (a) On 29 December 2009 a writ of execution was issued in accordance with clause 81(2) of the law "*about executive production and the status of legal executives*" authorising all state bodies and public officials to assist in the execution of the verdict of the Mangystau Regional Court on 12 November 2009 (**C-119**).
 - (b) On 10 January 2010, in accordance with 33, 34.i.1 and 86 of the Law "on enforcement and status of judicial executor, the Judicial executors attached a number of bank accounts owned by KPM (**Exhibit C-121**). The Claimants are put to proof as to what effect, if any, this had on the operation of KPM's business.
 - (c) On 22 January 2010 in accordance with 33, 34.i.1 and 86 of the Law "on enforcement and status of judicial executors", the Judicial executors orders attached to a number of vehicles (**Exhibit C-122**). The Claimants are put to proof as to what effect, if any, this had on the operation of KPM's business.
 - (d) On 25 January 2010, the Republic gave notice of an inventory that would take place of KPM's assets (**Exhibit C-124**) on 26 January 2010.
 - (e) On 19 February 2010, following persisting non-payment by KPM, the Judicial Executors ordered attachment of the assets found during the inventory in accordance with articles 33 ,34, 40 and 86 of the law "on enforcement and status of judicial executors".(**Exhibit C-125**).
 - (f) On 23 February 2010, import and export of oil to KazTransOil's (**KTO's**) pipeline was prohibited (**Exhibit C-298**).

- (g) On 26 February 2010, the Judicial Executors attached the trunk pipeline that had been the subject of litigation against Mr Cornegruta in accordance with articles 33 ,34, 40 and 86 of the law “on enforcement and status of judicial executors” (**Exhibit C-79**). The Claimants weakly allege at paragraph 131 that this order betrayed the Republic’s understanding of the “false pretences” under which Mr Corengruta had been arrested because it made mention of “field oil pipelines” when, according to the Republic the KPM Pipeline was in fact a trunk pipeline. In fact, a plain reading of the order clearly demonstrates that it made no such assertion. It merely states that the KPM Pipeline was designed to be a field pipeline and the KTO owns a system of trunk pipelines.
- (h) On 15 March 2010, further orders were made in accordance with articles 31, 43, 74, 75 and 86 of the law “on enforcement and status of judicial executors” (**Exhibit R-212**) over certain of KPM’s physical real property since the debt had still not been satisfied.
- (i) On 17 March 2010, the Aktau court suspended the orders made on 23 and 26 January 2010 (**Exhibit C-128**) in order to ensure that KPM’s/TNG’s business was not unduly affected by the execution orders.
- (j) On 9 June 2010, (**Exhibit C-199**) a sale of the KPM assets was ordered. As the Claimants conceded at paragraph 139, the assets were sold as a single lot to avoid a total suspension of KPM’s oil and gas activities.
- (k) On 15 June 2010 (**Exhibit C-201**), the Acting Chief of the Aktau Judicial Executors noted that the sale would not cover the debts of KPM under the Court’s judgment. A further warning was issued that if payment was not forthcoming measures would need to be taken within 2 weeks to enforce the decisions.

29.8 All enforcement measures were taken in accordance with the law¹³⁸ and were necessary because KPM failed to repay amounts properly owned by the Republic in accordance with the Court’s decision. All the actions taken and the documents relied upon to demonstrate that the Republic acted within its authority are set out in the Claimants’ own material. In each case,

- (a) the legislative basis of the order / writ was given;
- (b) notice regarding the serious implications for not complying with the order was given; and
- (c) information was provided regarding the process of appeal available in respect of each order made against KPM.

¹³⁸ Exhibit R-145

- 29.9 Further during the whole period of execution, care was taken not to overly disrupt KPM's business.
- 29.10 In any event, no evidence has been provided as to how each enforcement measure taken actually affected any of the claimants' alleged investments. Nor has any explanation been give as to why such the action taken was unjustified, particularly in circumstances where the Republic sought to recover income improperly vesting in KPM as a result of criminal activity and did so in accordance with due process.
- 29.11 Accordingly, the Claimants have failed to demonstrate that the measures complained of had any effect that might be relevant to evidence the alleged breaches against the Republic, be that discrimination, indirect expropriation or otherwise. In addition, the Claimants have also failed to demonstrate that any of the actions taken by the Claimants were in any way improper or contrary to Kazakh law.

30 The Republic's imposition of Corporate Back Taxes, Export Duties and Transfer Price taxes

THE REPUBLIC'S ANALYSIS

30.1 Declarations of the Claimant

- (a) Based on the results of tax inspections in relation to the companies "Kazpolmunay" and "Tolkynneftegaz" the Tax Committee of the Ministry of Finances of the Republic of Kazakhstan charged the following taxes payable to the budget in accordance with the provisions of the legislation of the Republic of Kazakhstan:
- (i) about 4.8 Million US Dollar of corporate income tax in connection with **transfer pricing**;
 - (ii) about 62 Million US Dollar of corporate income tax in connection with improper calculation of **amortization**;
- (b) Besides, about 3.7 Million US Dollar as payment of crude oil export tax was charged.
- (c) The Claimant declares the illegality of charging such amounts.

30.2 Tax measures of states and the ECT

Legal and illegal taxation measures of the state

- (a) By its very nature, taxation constitutes an involuntary seizure of property that bears some resemblance to expropriation. Wealth transfer through taxation remains involuntary. Taxpayers have no option to say: "Sorry, we'll just skip this year's contribution". Money

leaves private hands and enters into governmental coffers without any necessary (*quid pro quo*).

- (b) At the same time there is no doubt that the right to collect taxes is a sovereign right of the state that permits the modern state to function.
- (c) In light of taxation's special potential for abuse, many investment treaties contain intricate rules to assist in separating legitimate and illegitimate exercises of fiscal power. If the state is a participant to such treaties illegitimate cases of exercise of tax powers would be considered as expropriation.
- (d) In theory the contours of legitimate taxation leave many fuzzy edges. However one is obvious: differences do exist between what might be called "normal" and "abusive" taxes. "Normal" taxes are aimed to fund government. "Abusive" taxes are crafted to force abandonment of a business enterprise by ruining its economic value, or to provide an investor's competitors with privileges. One element common for most "abusive" tax measures are the arbitrary and unequal treatment to comparable taxpayers. At the same time a simple tax increase may not be considered as expropriation.¹³⁹
- (e) Article 21 the Energy Charter Treaty (ECT) establishes a general rule related to tax measures: "Nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties" (**Exhibit C-1**).¹⁴⁰
- (f) The same article then enumerates provisions that will apply within the ECT to tax measures: prohibitions against discrimination¹⁴¹ and uncompensated expropriation¹⁴².
- (g) Non-discrimination rule, however, excludes from its application both income and capital taxes. It shall not be applied either if the benefits are based on an interstate agreement on tax matters or if they are necessary to secure the effective tax collection (and at the same time do not represent arbitrary discrimination).

¹³⁹ See Christoph H. Schreuer. Fair and Equitable Treatment (FET); interactions with other standards. From the book Investment protection and the Energy charter Treaty, edited by Graham Coop and Clarisse Ribeiro; JurisNet, LLC, 2008, p.63-100 (**Exhibit R-146**).

¹⁴⁰ Other bilateral or multilateral investment regimes have analogous provisions. See e.g., NAFTA? Article 2103(4); 2004 US Model BIT, Article 21; US-Ecuador BIT, Article 10; Canada-Ecuador BIT, Article 12. See the text of these provisions in **Exhibit R-147**.

¹⁴¹ Article 21(3) says that Articles 10(2) and 10(7) "shall apply to taxation measures of the Contracting Parties other than those on income and on capital". These two subsections of Article 10 relate to non-discrimination and most-favoured-nation treatment. In its turn, exceptions to the exception exist inter alia for tax collection mechanisms or provisions of economic integration organizations and income tax treaties in Article 21(7)(a)(ii). The carve-out for tax on income and capital leave some of the most significant categories of fiscal measures, including value added tax, import and export duties, and stamp taxes. Specifically, the ECT exclusion does not refer to Article 10(1) mandating "fair and equitable treatment".

¹⁴² Article 21(5) of the ECT says that "Article 13 shall apply to taxes". Article 13(1)(d) requires compensation to be accompanied by the "payment of prompt, adequate and effective compensation".

- (h) When examining the claim raised by the Claimant it should be taken into account that taxation measures in form an additional charge of taxes are absolutely justified in case of legality of taxes.

30.3 Tax arbitration under the ECT

Doctrine and theory

- (a) Arbitration of tax-related disputes proves a practical reality notwithstanding objections of a doctrinal or theoretical nature. Despite lively scholarly debate¹⁴³, arbitrators address claims by foreign investors brought against host States. Moreover, for arbitration are submitted only those issues which can be examined in accordance with the treaty under which arbitration is carried out (if this treaty contains the state's waiver of immunity in this specific sphere).

Competent authority

- (b) Many investment treaties require that claims related to taxation measures may be sent to arbitration only after the matter has first be referred to the competent fiscal authorities.
- (c) Article 13 of the ECT ("Expropriation") shall apply to taxes taking into account the limitations established in paragraph 5 Article 21 of the ECT.¹⁴⁴ When **the question arises by virtue of Article 13 of the ECT of whether a tax is expropriation or discrimination**, the party shall refer this issue to the Competent Tax Authority. In case the investor or the contracting party fail to make such referral, the Arbitral Tribunal shall submit this issue for examination of Competent Tax Authorities of the contesting States.
- (d) Under a "competent tax authority" is meant a competent authority according to the effective Agreement on Avoidance of Double Taxation (and in the absence of such – the ministries in charge of taxation). In the Republic of Kazakhstan this is the Taxation Committee of the Ministry of Finances of the Republic of Kazakhstan.
- (e) Within the time limits established by the Kazakh legislation the competent tax authorities shall examine the issues referred to them and make decisions. The dispute settlement

¹⁴³ See generally, Bernard Hanotiau, L'Arbitrabilité (2003) in *Recueil des cours* (2002), Académie de Droit International de la Haye at 171-180; Pascal Ancel, 'Arbitrage et ordre public fiscal', 2001 *Rev. Arb.* 269; Matthieu de Boisseson, *Le Droit français de l'arbitrage* (1990), Section 33 (at 37); Ibrahim Fadallah, *L'ordre public dans les sentences arbitrales*, *Recueil de cours* (2002), Académie de Droit International de la Haye, 369 (1994) paras. 54-56, at 410-411; Philippe Fouchard, Emmanuel Gaillard & Berthold Goldman, *International Commercial Arbitration* (English Language edition, E. Gaillard & J. Savage eds., 1999) at 348 & 359 (Section 579, n.478, & 589-1). For a survey of ICC arbitration touching on tax matters, see Luca Melchionna, 'Tax Disputes and International Commercial Arbitration', *Diritto e Pratica Tributaria Internazionale* 74 (2003):769. See also Luca Melchionna, Arbitrability of Tax Disputes, IBA Section on Business Law, *Arbitration and ADR Committee Newsletter 21 (May 2004)* – ссылка по статье William W. Park. Tax arbitration and investor protection. From the book *Investment protection and the Energy Charter Treaty*, edited by Graham Coop and Clarisse Ribeiro; JurisNet, LLC, 2008, p.p.115-144 (**Exhibit R-148**).

¹⁴⁴ See **Exhibit C-1**

body (Arbitration court) shall consider all conclusions at which the Competent tax authorities arrive.

30.4 Illegal actions of the Claimant

- (a) The Claimant did not fulfil a condition precedent contained in Article 21 (5) of the ECT (**Exhibit C-1**). He did not refer to the Competent tax authority the issue of whether the taxation measures undertaken by the Republic of Kazakhstan constitute expropriation and whether they are discriminatory.
- (b) In line with provisions of Article 21 (5) of the ECT in case if the Claimant has failed to refer the issue for examination, the Arbitral Tribunal shall refer the issue to the Competent authorities of respective States and shall take into account the conclusion at which the Competent authorities will arrive within a six-month period.
- (c) However, the aforesaid concerns only those taxation measures which can be referred to Arbitration in accordance with Article 21. At the same time in line with paragraph 7 (d) Article 21 of the ECT the term “taxes” does not include customs duties. Hence, export customs duty is outside the scope of Article 21 of the ECT and may not be at all the subject-matter of arbitration. As far as the corporate income tax is concerned (paragraph 11.2.1 of the Statement of Defence), this tax, as we have already noted, may not be examined by the present Arbitral Tribunal in case if the issue relates to discrimination. Thus, in respect of the taxes concerned the Claimant can raise before the Competent Authority (or the Arbitral Tribunal before the respective Competent Authorities) only the issue of whether these two above mentioned tax measures on corporate income tax may be considered as expropriation. And only in that case if the Arbitral Tribunal does not receive the answer from the Competent Tax Authority within six months it has the right to make an independent decision on this issue.

30.5 Clarification of the Competent Tax Authority of the Republic of Kazakhstan:

The Kazakh tax system

- (a) The Republic has a well-developed system of tax assessment.
- (b) Article 35 of the Constitution of the Republic of Kazakhstan provides that payment of duly imposed taxes, fees and other compulsory contributions is the duty and obligation of every person in Kazakhstan (Exhibit R-91). Taxation is universal and compulsory in Kazakhstan and a key policy rationale of the legislation is to further the existence of a fixed, fair and transparent taxation system to assist the presentation of the correct amounts for taxation and the collection of taxes in accordance with due process. As is the case in the majority of developed countries, the failure to pay taxes results in an fine

under Article 48 and 209 of “The Code on Administrative Violations” (**Exhibit R-176**) and default interest on such unpaid tax under Article 610 of the “Tax Code” (**Exhibit R-70**).

- (c) In line with this overall policy, Kazakhstan aims to ensure that the overall burden on taxpayers is not too high. The average percentage of tax payable as against the income earned by persons in Kazakhstan is approximately 35%. When compared to other developed countries worldwide this percentage is very reasonable: the burden to pay Kazakhstan is not unduly harsh.
- (d) It is against this background that the Arbitral Tribunal should consider the failures of KPM and TNG to pay taxes required by them. In particular, when considering the tax paid by KPM and TNG the average percentage they were required to pay on the income they earned from 2004 to 2010 was:
- (e) For KPM 21.9% excluding customs duties and 22.5% including customs duties; and
- (f) For TNG 16.7% excluding customs duties and 21.2% including customs duties¹⁴⁵,
- (g) Based on the above, the tax imposed on KPM and TNG was not burdensome and well below the average paid by persons in Kazakhstan. It is therefore surprising that the Claimant makes complaints about the overall fairness of the taxes it was required to pay.
- (h) The Respondent has tentatively obtained the clarification of the Competent Authority of the Republic of Kazakhstan (**Exhibit R-149**) on the issue that payments charged additionally on “Kazpolmunay” LLP and “Tolkynneftegaz” LLP when calculating corporate income tax in the amount of approximately 4,8 million US Dollar in connection with transfer pricing and approximately 62 million US Dollar in connection with incorrect calculation of amortization are absolutely lawful.
- (i) Tax Committee carried an audit of KPM and TNG that it was entitled to carryout under KPM and TNG’s Subsoil Contracts and Kazakh legislation. As a result the Tax Committee determined that KPM and TNG were obliged to pay corporate back taxes. That determination was confirmed by the Astana Economic Court and Supreme Court.
- (j) KPM and TNG failed to pay the corporate back taxes.
- (k) As such, far from being a damning tale of harassment by the Republic, the Claimants tale of audits and taxes amounts yet another example of KPM and TNG failing to pay the taxes due in breach of both Kazakh law and their respective Subsoil Contracts.

¹⁴⁵ This is from the report titled “Claim for refund of taxes paid on income generated in the Republic of Kazakhstan in an amount exceeding USD500m”. The source of these figures is required.

- (l) Accordingly, whilst the Arbitral Tribunal does not need to examine the issue in detail, it having been resolved by the Kazakh courts and the Ministry of Finance, which are the Competent Tax Authorities, it is clear that the tax and penalty charges complained of are neither expropriation nor discriminatory.
- (m) The competent authority also confirmed that the export customs duty is not a tax in accordance with the legislation of the Republic of Kazakhstan (**Exhibit R-150**). In its turn, the Customs Control Committee of the Ministry of Finance of the Republic of Kazakhstan confirmed the correctness of imputation of the export tax duty according to the legislation of Kazakhstan.
- (n) Accordingly there can be no proper suggestion that the export duty was wrongly assessed.

FURTHER ANALYSIS

Summary of the Claimants' and Republic's positions

- 30.6 The Claimants complain at paragraphs 156 to 179 of the SoC that as part of an orchestrated campaign of harassment the Republic conducted a series of tax audits in October and November 2008 and used the results of those audits to impose significant back tax and penalty charges on KPM and TNG including corporate taxes, export duties and transfer price taxes.
- 30.7 In respect of the audits, the Republic's position is that the audits were lawful, both from the perspective of the Claimants' Subsoil Contracts and Licences and the relevant Kazakh legislation and cannot therefore be considered a campaign of harassment, as discussed above at paragraphs 19 and 20.
- 30.8 As to the taxes, their lawfulness is a matter of Kazakh law. To the extent that KPM and TNG paid the charges, those charges have been scrutinised and approved by the Kazakh courts or cancelled and withdrawn, so neither KPM nor TNG can be said to have suffered any unlawful burden as a result.
- 30.9 To the extent that the Claimants rely on tax charges in support of their claim of direct or indirect expropriation, the matters complained of by the Claimants relate to Taxation Measures of the Republic under Article 21(7) of the ECT. Pursuant to Article 21(5) of the ECT those measures have been determined by the Competent Tax Authorities not to constitute expropriation or discrimination, by virtue of the fact that, to the extent that KPM or TNG paid the relevant taxes and penalties, they were lawful according to the relevant Kazakh legislation.
- 30.10 Accordingly, whilst the Arbitral Tribunal does not need to examine the issue in detail, it having been resolved by the Kazakh courts and the Ministry of Finance (which is the Competent Tax

Authority), it is clear that the tax and penalty charges complained of are neither expropriation nor discriminatory.

30.11 However, for the sake of completeness, the Republic sets out below a brief response to the Claimants assertions as regards the imposition of taxes by the Republic.

Status of the Tax Committee and the Customs Committee

30.12 The first point the Republic would like to address is the distinction between the operation of the Customs Committee and the Tax Committee. The Claimants present these two committees either as two entities operating in concert or as a single entity for all practical purposes. This is entirely incorrect.

30.13 Although each committee comes under the umbrella of the Ministry of Finance, each has a distinct set of powers and responsibilities and operates independently of the other.

30.14 For the avoidance of doubt, in relation to the Claimants' complaints concerning taxes and other payments:

- (a) The Customs Committee has responsibility in relation to export duties; and
- (b) The Tax Committee has responsibility in relation to corporate back taxes, rent taxes and taxes relating to transfer pricing.

The taxes are Tax Measures under Article 21 of the ECT

30.15 By its very nature, taxation constitutes an involuntary seizure of property that bears some resemblance to expropriation. Wealth transfer through taxation remains involuntary. Taxpayers have no option to say: "Sorry, we'll just skip this year's contribution". Money leaves private hands and enters into governmental coffers without any necessary (*quid pro quo*).

30.16 At the same time there is no doubt that the right to collect taxes is a sovereign right of the state that permits the modern state to function.

30.17 In light of taxation's special potential for abuse, many investment treaties contain intricate rules to assist in separating legitimate and illegitimate exercises of fiscal power. If the state is a participant to such treaties illegitimate cases of exercise of tax powers would be considered as expropriation.

30.18 In theory the contours of legitimate taxation leave many fuzzy edges. However one is obvious: differences do exist between what might be called "normal" and "abusive" taxes. "Normal" taxes are aimed to fund government. "Abusive" taxes are crafted to force abandonment of a business enterprise by ruining its economic value, or to provide an investor's competitors with privileges. One element common for most "abusive" tax measures are the arbitrary and unequal treatment

to comparable taxpayers. At the same time a simple tax increase may not be considered as expropriation.¹⁴⁶

Effect of Article 21 of the ECT in the present case

- 30.19 Article 21 the Energy Charter Treaty (ECT) establishes a general rule related to tax measures: “Nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties” (**Exhibit C-1**).¹⁴⁷
- 30.20 The same article then enumerates provisions that will apply within the ECT to tax measures: prohibitions against discrimination¹⁴⁸ and uncompensated expropriation¹⁴⁹.
- 30.21 Non-discrimination rule, however, excludes from its application both income and capital taxes. It shall not be applied either if the benefits are based on an interstate agreement on tax matters or if they are necessary to secure the effective tax collection (and at the same time do not represent arbitrary discrimination).
- 30.22 When examining the claim raised by the Claimant it should be taken into account that taxation measures in the form of an additional charge of taxes are absolutely justified in case of legality of taxes.
- 30.23 Arbitration of tax-related disputes proves a practical reality notwithstanding objections of a doctrinal or theoretical nature. Despite lively scholarly debate¹⁵⁰, arbitrators address claims by foreign investors brought against host States. Moreover, for arbitration only those issues which can be examined in accordance with the treaty under which arbitration is carried out are submitted (if this treaty contains the state’s waiver of immunity in this specific sphere).

¹⁴⁶ See Christoph H. Schreuer. Fair and Equitable Treatment (FET); interactions with other standards. From the book Investment protection and the Energy charter Treaty, edited by Graham Coop and Clarisse Ribeiro; JurisNet, LLC, 2008, p.63-100 (**Exhibit R-146**).

¹⁴⁷ Other bilateral or multilateral investment regimes have analogous provisions. See e.g., NAFTA? Article 2103(4); 2004 US Model BIT, Article 21; US-Ecuador BIT, Article 10; Canada-Ecuador BIT, Article 12. See the text of these provisions in **Exhibit R-147**.

¹⁴⁸ Article 21(3) says that Articles 10(2) and 10(7) “shall apply to taxation measures of the Contracting Parties other than those on income and on capital”. These two subsections of Article 10 relate to non-discrimination and most-favoured-nation treatment. In its turn, exceptions to the exception exist inter alia for tax collection mechanisms or provisions of economic integration organizations and income tax treaties in Article 21(7)(a)(ii). The carve-out for tax on income and capital leave some of the most significant categories of fiscal measures, including value added tax, import and export duties, and stamp taxes. Specifically, the ECT exclusion does not refer to Article 10(1) mandating “fair and equitable treatment”.

¹⁴⁹ Article 21(5) of the ECT says that “Article 13 shall apply to taxes”. Article 13(1)(d) requires compensation to be accompanied by the “payment of prompt, adequate and effective compensation” (**Exhibit C-1**).

¹⁵⁰ See generally, Bernard Hanotiau, L’Arbitrabilité (2003) in *Recueil des cours* (2002), Académie de Droit International de la Haye at 171-180; Pascal Ancel, ‘Arbitrage et ordre public fiscal’, 2001 *Rev. Arb.* 269; Matthieu de Boisseson, *Le Droit français de l’arbitrage* (1990), Section 33 (at 37); Ibrahim Fadallah, *L’ordre public dans les sentences arbitrales*, *Recueil de cours* (2002), Académie de Droit International de la Haye, 369 (1994) paras. 54-56, at 410-411; Philippe Fouchard, Emmanuel Gaillard & Berthold Goldman, *International Commercial Arbitration* (English Language edition, E. Gaillard & J. Savage eds., 1999) at 348 & 359 (Section 579, n.478, & 589-1). For a survey of ICC arbitration touching on tax matters, see Luca Melchionna, ‘Tax Disputes and International Commercial Arbitration’, *Diritto e Pratica Tributaria Internazionale* 74 (2003):769. See also Luca Melchionna, Arbitrability of Tax Disputes, IBA Section on Business Law, *Arbitration and ADR Committee Newsletter* 21 (May 2004)

Taken from an article by William W. Park. Tax arbitration and investor protection. From the book Investment protection and the Energy Charter Treaty, edited by Graham Coop and Clarisse Ribeiro; JurisNet, LLC, 2008, p.p.115-144 (**Exhibit R-148**).

30.24 Many investment treaties require that claims related to taxation measures may be sent to arbitration only after the matter has first been referred to the competent fiscal authorities.

30.25 The notices by which taxes were imposed on KPM and TNG, of which the Claimants complain, are Taxation Measures within the meaning of Article 21(7)(a) of the ECT, which provides:

“For the Purpose of this Article:

(a) The term “Taxation Measure” includes:

(i) any provision relating to taxes of the domestic law of the Contracting Party or of a political subdivision thereof or a local authority therein; and

(ii) any provision relating to taxes of the taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement by which the Contracting Party is bound.” (Exhibit C-1)

30.26 As regards the ECT’s application to Taxation Measures Article 21 of the ECT further provides:

“(1) Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties. In the event of any inconsistency between this Article and any other provision of the Treaty, this Article shall prevail to the extent of the inconsistency

...

(5)

(a) Article 13 shall apply to taxes:

(b)

(i) The Investor or the Contracting Party alleging expropriation shall refer the issue of whether the tax is an expropriation or whether the tax is discriminatory to the relevant Competent Tax Authority...

(ii) The Competent Tax Authorities shall, within a period of six months of such referral, strive to resolve the issues so referred...

(iii) Bodies called upon to settle disputes pursuant to Article 26(2)(c) or 27(2) may take into account any conclusions arrived at by the Competent Tax authorities regarding whether the tax is an expropriation”¹⁵¹

30.27 Thus Article 13 of the ECT (“Expropriation”) shall apply to taxes taking into account the limitations established in paragraph 5 Article 21 of the ECT.¹⁵² When the question arises by virtue of Article 13 of the ECT of whether a tax is expropriation or discrimination, the party shall refer this issue to the Competent Tax Authority. In case the investor or the contracting party fail to make such referral, the Arbitral Tribunal shall submit this issue for examination of Competent Tax Authorities of the contesting States.

30.28 The Ministry of Finance of the Republic of Kazakhstan, of which the Taxation Committee and the Customs Committee are sub-divisions, is the Competent Tax Authority for the Republic within the meaning of Article 21(7)(c) of the ECT, which provides:

“A ‘Competent Tax Authority’ means the competent authority pursuant to a double taxation agreement in force between the Contracting Parties or, when no such agreement is in force, the minister or ministry responsible or their authorised representatives.”

(Exhibit C-1)

30.29 Within the time limits established by the Kazakh legislation the competent tax authorities shall examine the issues referred to them and make decisions. The dispute settlement body (in this case the Arbitral Tribunal) shall consider all conclusions at which the Competent Tax Authority arrives.

Reference to the Competent Tax Authority

30.30 The Claimants did not fulfil a condition precedent contained in Article 21 (5) of the ECT¹⁵³ in that they did not refer to the Competent Tax Authority the issue of whether the taxation measures undertaken by the Republic of Kazakhstan constitute expropriation and whether they are discriminatory.

30.31 In line with provisions of Article 21 (5) of the ECT¹⁵⁴ if the Claimant has failed to refer the issue for examination, the Arbitral Tribunal shall refer the issue to the Competent authorities of respective States and shall take into account the conclusion at which the Competent authorities will arrive within a six-month period.

30.32 However, the aforesaid concerns only those taxation measures which can be referred to Arbitration in accordance with Article 21. At the same time in line with paragraph 7 (d) Article 21

¹⁵¹ Exhibit C-1

¹⁵² Exhibit C-1

¹⁵³ Exhibit C-1

of the ECT¹⁵⁵ the term “taxes” does not include customs duties. Hence, export customs duty is outside the scope of Article 21 of the ECT and may not be at all the subject-matter of arbitration. As far as the corporate income tax is concerned (paragraph 11.2.1 of the Statement of Defence), this tax, as we have already noted, may not be examined by the present Arbitral Tribunal if the issue relates to discrimination. Thus, in respect of the taxes concerned the Claimant can raise before the Competent Authority (or the Arbitral Tribunal before the respective Competent Authorities) only the issue of whether these two above mentioned tax measures on corporate income tax may be considered as expropriation. And only in that case if the Arbitral Tribunal does not receive the answer from the Competent Tax Authority within six months it has the right to make an independent decision on this issue.

Opinion of the Competent Authority

- 30.33 The Republic has tentatively obtained the Opinion of the Competent Authority of the Republic of Kazakhstan (Exhibit R-149) on the issue that payments charged additionally to KPM and TNG when calculating corporate income tax in the amount of approximately 4.8 million US Dollar in connection with transfer pricing and approximately 62 million US Dollar in connection with incorrect calculation of amortization are absolutely lawful.
- 30.34 Accordingly, whilst the Arbitral Tribunal does not need to examine the issue in detail, it having been resolved by the Kazakh courts (being the courts of competent jurisdiction) and the Ministry of Finance (being the, Competent Tax Authority), it is clear that the tax and penalty charges complained of are neither expropriation nor discriminatory.
- 30.35 The Competent Tax Authority also confirmed that the export customs duty is not a tax in accordance with the legislation of the Republic of Kazakhstan (Exhibit R-149). In its turn, the Customs Control Committee of the Ministry of Finance of the Republic of Kazakhstan confirmed the correctness of imputation of the export tax duty according to the legislation of Kazakhstan.
- 30.36 The Arbitral Tribunal has been called on to settle the current dispute pursuant to Article 26.2(c) and should agree with the conclusion of the Ministry of Finance that the Taxation Measures of which the Claimants complain do not constitute expropriation under Article 13 of the ECT and are not discriminatory.

The Kazakh tax system

- 30.37 The Republic has a well-developed system of tax assessment.
- 30.38 Article 35 of the Constitution of the Republic of Kazakhstan (**Exhibit R-91**) provides that payment of duly imposed taxes, fees and other compulsory contributions is the duty and obligation of

¹⁵⁴ Exhibit C-1

every person in Kazakhstan. Taxation is universal and compulsory in Kazakhstan and a key policy rationale of the legislation is to further the existence of a fixed, fair and transparent taxation system to assist the presentation of the correct amounts for taxation and the collection of taxes in accordance with due process. As is the case in the majority of developed countries, the failure to pay taxes results in a fine under Article 48 of “*The Code on Administrative Violations*” (**Exhibit R-176**) and default interest on such unpaid tax under Article 610 (1) of the “*Tax Code*” of the Republic of Kazakhstan (**Exhibit R-70**).

30.39 In line with this overall policy, Kazakhstan aims to ensure that the overall burden on taxpayers is not too high. The average percentage of tax payable as against the income earned by persons in Kazakhstan is approximately 35%. When compared to other developed countries worldwide this percentage is very reasonable: the burden to pay Kazakhstan is not unduly harsh.

30.40 It is against this background that the Arbitral Tribunal should consider the failures of KPM and TNG to pay taxes required by them. In particular, when considering the tax paid by KPM and TNG the average percentage they were required to pay on the income they earned from 2004 to 2010 was:

- (a) For KPM 21.9% excluding customs duties and 22.5% including customs duties; and
- (b) For TNG 16.7% excluding customs duties and 21.2% including customs duties¹⁵⁶,

30.41 Based on the above, the tax imposed on KPM and TNG was not burdensome and well below the average paid by persons in Kazakhstan. It is therefore surprising that the Claimant makes complaints about the overall fairness of the taxes it was required to pay.

KPM and TNG’s history of non payment of taxes

30.42 The emphasis the Claimants place on the supposed harassment they have suffered from these tax audits is rather surprising, considering that KPM and TNG have repeatedly failed to comply with its tax obligations in the past.

30.43 In relation to KPM:

- (a) For the period 1 January 2003 to December 31, 2004 (Act of September 9, 2005 № 32), KPM was assessed as being required to pay an additional 15,246.9 thousand Tenge, including taxes of 13,072.1 thousand Tenge and 2,174.8 thousand Tenge in penalties. The failure to pay such taxes was comprised of violations of its obligations to pay VAT, Royalty and rent tax on exported crude oil. It was also required to reduce its reported losses by 18,570.3 thousand Tenge due to its improper allocation of expenditure on

¹⁵⁵ Exhibit C-1

exploration and geological prospects. KPM agreed to pay these amounts and did not challenge the results and the legitimacy of the tax audit.

- (b) A thematic tax audit was also carried out for the period 1 January 2001 to 31 December 2003 (Act of May 17, 2005, № 5), and it was assessed that additional 2,154.4 thousand Tenge, including taxes of 1,550.0 thousand Tenge and 604.4 thousand Tenge of penalties was payable. KPM was also required to reduce its losses of 76,876.5 thousand Tenge for transfer prices of crude oil in foreign companies, including companies registered in countries with preferential tax treatment. KPM agreed to these additionally charged amounts and did not challenge the results and the legitimacy or legality of the tax audit.

30.44 In relation to TNG:

- (a) In 2002 (Act of 19 December 2007 № 2848) TNG was assessed as being required to pay an additional 338.8 thousand Tenge, including taxes of 252.1 thousand Tenge and penalties of 86.7 thousand Tenge. The taxes related to TNG's failure to pay VAT, Investment Income Tax and Social Tax. TNG agreed to the additionally charged amounts and further did not challenge the results and the legitimacy of the tax audit.
- (b) For the period from 1 January 2003 to December 31, 2004 (Act of 30 December 2008 № 3116) TNG was assessed as being required to pay an additional 6,655.9 thousand Tenge, including taxes of 4,157.2 thousand Tenge (for unpaid social tax) and 2,498.7 thousand Tenge in penalties. Its reduced losses were assessed at 3,023,132.7 thousand Tenge (due to improper allocation of expenditure on exploration and geological prospecting as a deduction). TNG agreed to these additionally charged amounts and further did not challenge the results and the legitimacy of the tax audit.

30.45 KPM and TNG have therefore both repeatedly failed to pay the taxes they were required to pay and it should come as no surprise that they were subject to further investigation.

KPM and TNG's contractual obligations to pay tax

30.46 Under their respective Subsoil Contracts, KPM and TNG were obliged to pay taxes as follows:

- (a) For KPM under Subsoil Contract 305:

"7.2 The Contractor is obliged to:

7.2.14 Pay taxes and transfer other obligatory payments in time."

- (b) For TNG under Subsoil Contract 210:

"6.2 The Contractor is obliged to:

6.2.16 Pay taxes and other obligatory payments in due time according to the Legislation and the Contract.”

- (c) For TNG under Subsoil Contact 302

“6.2 The Contractor is obliged to:

6.2.16 Pay in due time taxes and other obligatory payments in accordance with the Legislation and this Contract”.

- 30.47 In light of the above, the Republic was justified in citing a failure to pay taxes as one of the breaches of KPM and TNG’s Subsoil Use Contracts in its notices to KPM and TNG of 14 July 2010.

Corporate back taxes

- 30.48 As established at paragraphs 19 and 20 above, the audit initiated by the Tax Committee on 10 November 2008 (paragraph 156 of the SoC) was a legitimate exercise of the Tax Committee’s powers of inspection. It cannot therefore be considered “harassment”, as alleged by the Claimants.

- 30.49 The Claimants’ allegation that the audit *“had not found anything legitimately wrong”* (paragraph 157 of the SoC) is self evidently incorrect as they then go on to note that the Tax Committee found that KPM and TNG had improperly amortized drilling expenses for the years 2005 to 2007. The Claimants suggestion that the audit found *“nothing legitimately wrong”* and that the improper amortisation was *“invented”* are purely assertions of the Claimants’ position and have no basis in fact.

- 30.50 In support of these assertions the Claimants refer in very general terms to clauses of and amendments to the KPM and TNG Subsoil Use Contracts concerning tax treatment. The Claimants contend that the effect of these clauses and amendments is to preserve the application of specific provisions of the tax legislation in force on 1 April 1999 (SoC 158). However they go on to admit that after a year and a half of litigation, the Astana Court determined that the Tax Committee’s interpretation of the provisions concerning amortization was correct (SoC 159 and footnote 314).

- 30.51 In summary the Claimants’ violations included:

- (a) For KPM, during the period from 1 January 2005 to December 31, 2007 (Act of February 10, 2009 № 28), the Republic’s assessment revealed that an additional 3,257,446.0 thousand Tenge was payable, including taxes of 2,255,207.8 thousand Tenge and penalties of 1,002,238.2 thousand Tenge. The unpaid taxes KPM failed to pay related to corporate income tax (as a result of it improperly allocating expenditure relating to exploration and geological prospects as a deduction) and investment income tax (as a result of it making payments for training for individuals that were not employees).

- (b) For TNG, for the period from 1 January 2005 to December 31, 2007 (Act of February 10, 2009 № 29), an assessment that TNG was liable to pay an additional 5,906,027.2 thousand Tenge, including taxes of 4,007,727.4 thousand Tenge and penalties of 1,898,299.8 Tenge. TNG was also required to reduce its losses by 1,558,600.2 thousand Tenge. The taxes KPM failed to pay related to corporate income tax (as a result of it improperly allocating expenditure relating to exploration and geological prospects as a deduction) and royalty tax (as a result of it incorrectly identifying transportation costs, and therefore applying a lower tax base for calculating the royalty for the audited period).

30.52 Although they note that KPM and TNG appealed the decision of the Astana Court, the Claimants provide no explanation of the procedural or substantive basis for this appeal, which ultimately was never heard. Accordingly, the judgment of the Astana Court still stands and there is basis for the Claimants assertion that the corporate back taxes and penalties imposed by the Tax Committee were incorrect.

30.53 Furthermore it is noted that at no point did KPM and TNG ever pay the corporate back taxes or penalties demanded. This is acknowledged by the Claimants, in relation to KPM, where they note that these sums formed part of the basis of the application by the Ministry of Finance to the Specialized Interdistrict Economic Court of Mangystau Region for the external management of KPM (SoC 160).

Export Duties

30.54 The Claimants have presented wholly inaccurate case in relation to export duties. They have muddled together events from separate streams of correspondence with the Customs Committee, in an effort to present the most prejudicial picture possible. The accuracy of their portrayal of event is denied as is the assertion that the Customs Committee sought to or in fact harassed KPM and/or TNG.

30.55 In the relevant period there two sets of export duties. The first was initiated following a lawful investigation of KPM by the Customs Committee as the Claimants relate (SoC 161). However, it did not relate to and nor was it influenced by any investigation by the Financial Police.

30.56 The chain of events relating to the first set of export duties is as follows:

- (a) The Customs Committee notified KPM that it was liable to pay export duties on its crude oil exports.
- (b) KPM challenged that decision in the Kazakh Courts as the Claimants say (SoC 163) and the Specialized Interdistrict Court of Mangystau Region delivered judgement in KPM's favour on 19 November 2008 (SoC 164).

- (c) The decision of the Specialized Interdistrict Court of Mangystau Region was subsequently cancelled on procedural grounds on 23 December 2009 by the Board of Appeal of the Mangystau Regional Court (SoC 164 and C-161).
- (d) Subsequently on 24 February 2010 the Regional Customs Committee issued a fresh notice to KPM concerning its liability for export duties (C-44) it also issued a notice to TNG concerning its liability to pay export Duties (C-44).
- (e) On 31 March 2010 the Central Customs Committee cancelled the notification issued by the Regional Customs Committee and the export duty charges were effectively withdrawn.

30.57 In the course of these events, KPM made a payment of approximately \$700,000 in respect of the relevant customs duties. This payment was returned following withdrawal of the charges. It is denied that KPM paid \$10m in relation to these charges or that such an amount was wrongfully retained by the Republic (SoC 163 and SoC165).

30.58 The second set of export duties were initiated against KPM by the Customs Committee in September 2010. The charges amounted to \$3.7m. As matters stand the charges have not been paid by KPM. The Claimants offer no explanation or evidence as to why these charges are unlawful.

30.59 Save as set out above, the Claimants' assertions in relation to export duties are denied.

The Transfer Price taxes

30.60 As noted above, the Claimants rely on this issue in relation to alleged harassment only.

30.61 Although the Claimants' description of the Kazakh transfer price regulatory mechanism is not admitted (SoC 172), in common with countries including, for example, Germany, Kazakhstan regulates transfer pricing activities to prevent companies avoiding taxes by artificially depressing their reported sales. In very basic terms, where a company reports sales of goods at below market value they are required to prove that sales were in fact made at these prices. Where the company cannot provide such proof, for the purpose of calculating taxes, its revenue is adjusted upwards by reference to the differential between the reported sale price and the market price.

30.62 The transfer price taxes arose from a lawful audit of KPM in relation to transfer prices. It is not admitted that the audit was instructed by the Financial Police. The letter of the Tax Committee of 11 November 2008 (C-38) shows only that the Tax Committee disclosed information relating to the audit at the request of the Financial Police. It is denied that the relevant audit constituted any form of harassment or that it was intended to harass KPM.

- 30.63 As is apparent from the notices sent to KPM and TNG dated 29 December 2009 (**C-137 and C-138**) that:
- (a) In relation to KPM the audit revealed underpayments of 191,391,320 Tenge, to which a late payment charge of 196,254,044 Tenge was added.
 - (b) In relation to TNG the audit revealed underpayments of 172,766,494 Tenge to which a late payment charge of 154,900,840 Tenge was added.
- 30.64 These assessments were made in accordance with Article 607 of the Code of the Republic of Kazakhstan “On taxes and other obligatory payments to the budget” (**C-137 and C-138**).
- 30.65 The Claimants’ assertion that these assessments were wrong (**SoC 174**) is denied. KPM and TNG sought to challenge these assessments in the Kazakh courts. Their challenges were refused by the first instance court on 9 July 2010 and 12 July 2010 respectively. Those first instance decisions were upheld on appeal on 16 September 2010
- 30.66 Accordingly, it is denied that the assessment of transfer price taxes was wrong or that KPM or TNG suffered any form of harassment as a result.

Summary analysis and Conclusion of the Claimants’ complaint as to taxes

- 30.67 Within their allegation of “harassment” the Claimants allege that the Republic wrongfully assessed and enforced payment of certain taxes and levies including:
- (a) Corporate taxes;
 - (b) Export duties; and
 - (c) Taxes arising and audit of transfer pricing.
- 30.68 Whilst the Claimants seek to create the impression that KPM and TNG were subject to a barrage of financially crippling and arbitrary taxes, on analysis it is apparent that:
- (a) In relation to corporate taxes, these relate only to KPM. They were determined to be lawful by the Kazakh Courts and have not been paid.
 - (b) In relation to export duties, the first phase of charges related to KPM and TNG. The charges were withdrawn for both companies. KPM had paid \$700,000 in respect of the charges. This money was refunded following withdrawal of the charges. TNG paid nothing. In relation the second phase of charges, these relate to £3.7m and have not been paid.

(c) In relation to taxes arising from the transfer price audit, these relate to KPM and TNG. The charges have been determined to be lawful by the Kazakh Courts. Neither company has paid the charges.

30.69 Accordingly the supposedly damning entire history of events recounted by the Claimants in SoC 156 to 174 amounts to:

(a) KPM failed to pay lawfully imposed corporate back taxes.

(b) KPM and TNG failed to pay lawfully imposed export taxes.

(c) KPM and TNG failed to pay lawfully imposed taxes arising from a transfer pricing audit.

30.70 As such, far from being a damning tale of harassment by the Republic, the Claimants' tale of audits and taxes amounts yet another example of KPM and TNG failing to pay the taxes due in breach of both Kazakh law and their respective Subsoil Contracts.

31 Terminating the contracts for breach and invoking the trust management system

31.1 In its Statement of Claim the Claimants declare the following: On July 21-22, 2010, Kazakhstan directly and unlawfully expropriated all of the Claimants' Kazakh investments by unilaterally cancelling Subsoil Use Contracts of "Tolkynneftegaz" LLP and TOO "Kazpolmunay", by transferring the assets of "Tolkynneftegaz" LLP and "Kazpolmunay" LLP to the national company KazMunaiGas. The expropriation was based on the eighteen alleged Subsoil Use Contract violations which were admitted by "Tolkynneftegaz" LLP and TOO "Kazpolmunay". (see paragraphs 7, 253, 386 of the Statement of Claim).

31.2 Notices requiring the elimination of violations of the contracts were received by "Tolkynneftegaz" LLP and "Kazpolmunay" LLP on 14 July 2010 when the competent authority (the Ministry of Oil and Gas of the Republic of Kazakhstan) did not possess the results of the unscheduled inspection carried out in July 2010 (see the Response of "Tolkynneftegaz" LLP № 1341tng dated 19 July 2010) (**Exhibit C-26.2**) and the Response of "Kazpolmunay" LLP № 841kpm dated 19 July 2010 (**Exhibit C-24.2**)).

31.3 Moreover for elimination of the listed violations the unreasonably short time was granted to "Tolkynneftegaz" LLP and "Kazpolmunay" LLP for preparation of responses which constituted a violation of due process (see paragraphs 209 and 312 of the Statement of Claim). The Claimants allege that the Republic acted in bad faith having unilaterally repudiated the Subsoil Use Contracts of "Tolkynneftegaz" LLP and "Kazpolmunay" LLP and having illegally seized Kazakh investments."

A Determination of the law applicable to Contracts № 210 and № 305 the scope of its application: general provisions

Applicable law

- 31.4 In line with paragraph 22.1 of Contract № 210 (**Exhibit C-52**) and paragraph 27.1 of Contract № 305 (**Exhibit C-45**) the mentioned contracts (as well as other agreements signed on the basis of the Contract) shall be governed by the law of the Republic of Kazakhstan.

Grounds and procedure of termination of subsoil use contracts established by the Republic of Kazakhstan and applied to termination of contracts № 210 and № 305

- 31.5 The procedure of termination of subsoil use contracts is established by the Republic of Kazakhstan in the Law "On Subsoil and Subsoil Use" (**the Subsoil Law**). According to paragraph 2 Article 72 of the Subsoil Law early termination of the contract at the request of either party shall be permitted in cases provided for by the Subsoil Law (**Exhibit R-152**). Paragraph 3 Article 72 of the Subsoil Law provides for the cases where the competent authority has the right to a unilateral termination of the contract.
- 31.6 It should be noted that in case of termination of the subsoil use contract the competent authority shall act as a party to the contract and not as a state performing its sovereign functions.
- 31.7 Contracts № 210 and № 305 were terminated in advance by a competent authority as a party to the Contracts on ground provided for by subparagraph 1 paragraph 3 Article 72 of the Subsoil Law (in consideration of provisions of paragraph 22.1 of Contract № 210) (**Exhibit C-52**) and paragraph 27.1 of Contract № 305 (**Exhibit C-45**): in case of a failure of the subsoil user to eliminate (within the time specified in the notice of the competent authority) of more than two violations of obligations established by the subsoil use contract or design documentation. In the case of a failure of the subsoil user to completely eliminate the violations of the contract terms within the time period fixed in the notice of the competent authority, the competent authority shall have the right to unilateral termination of the contract.

Trust management

- 31.8 By virtue of paragraph 10 Article 72 of the Subsoil Law the legal consequences of early termination by the competent authority of a subsoil use contract shall be a transfer of the contract area into trust management by a national company as well as a transfer of facilities and equipment to ensure the continuity of the process and industrial safety by a former subsoil user into a temporary possession and use by the national company, for a period prior to the transfer of property to a new subsoil user. This mechanism is very important for a well tuned work under the contract, since it is not always possible to interrupt it without damaging the deposit or the environment and creating social tension in the region.

- 31.9 One should take into account that trust management in no case should be mistaken with a well-known to the anglo-american system institute of trust. As distinct from trust, relations on trust management are of obligatory character.
- 31.10 A trust manager can not be regarded as a trustee. Property is transferred to him on a temporary basis in possession and use however legally it continues to be regarded as a property of the owner. The owner of the property after transfer of property into trust management continues to be liable with this property under its obligations.

Possibility of renewal of the contracts

- 31.11 In accordance with Article 72 of the Subsoil Law, early termination of a subsoil use contract is not a termination of a contract in terms of the civil law. This is a kind of sanction which is applied by the State in respect of a subsoil user in case of violation of its obligations under the contract. A subsoil user may eliminate the violations and request the State to renew the contract.
- 31.12 Article 73 of the Subsoil Law provides for that the competent authority shall have the right to reinstate (on an out-of-court basis) the previously terminated by his initiative contract for exploration, production, combined exploration and production through a decision to renew the contract and the cancellation of an earlier decision to terminate the contract at the initiative of the competent authority.
- 31.13 In case of the competent authority making a decision to renew the contract and to cancel the earlier decision on the contract termination at the initiative of the competent authority the competent authority and the subsoil user shall agree upon the issues of the contract renewal, including the issues of responsibility, according to the established procedure.
- 31.14 Basis for consideration by the competent authority of the renewal of the previously terminated at the initiative of the competent authority contract is the application of the person the contract with whom was terminated.
- 31.15 In case of renewal of the contract, the contract area transferred into trust management as well as the property transferred into temporary possession and use by a national company shall be returned to the subsoil user.
- 31.16 The Republic often engages with subsoil users on the reinstatement of their contracts. Information regarding such negotiations is set out at (**Exhibit R-153**).
- 31.17 However neither "Tolkynneftegaz" LLP nor "Kazpolmunay" LLP has applied to the competent authority for reinstatement of the terminated Contracts № 210 and № 305 in accordance with the opportunity offered by the Subsoil Law which gives grounds to believe that the Claimants are not interested in maintenance of the contracts and carrying out further activities under them.

31.18 Termination of Contracts № 210 and № 305

Violation of obligations

31.19 On 14 July 2010 the competent authority (Ministry of Oil and Gas of the Republic of Kazakhstan) within its competences conferred on it in accordance with article 17 of the Subsoil Law (**Exhibit R-152**) notified “Tolkynneftegaz” LLP and “Kazpolmunay” LLP of violations of obligations under Contracts № 210 and № 305, respectively. The competent authority asked to submit to it till 19 July 2010 explanations of the reasons for non-fulfillment of obligations and all necessary documents proving that such violations were removed as well as to notify of the measures taken for prevention of such violations in the future (see Notices of 14 July 2010, ref. № 14-05-4924 (**Exhibit C-6**) and ref. № 14-05-4923 (**Exhibit C-2**)).

31.20 In this case violation of the following obligations were concerned:

Under Contract № 210:

- non-submission of information on implementation of work programs (paragraph 6.2.10 Contract № 210, subparagraph 13) paragraph 1 Article 76 of the Subsoil Law);
- non-submission of the enclosure to the report on money spending of the persons sent for training with indication of the trainees, list of training programs, training organizations, dates of training (paragraph 6.2.13 of Contract № 210);
- non-fulfillment of obligations for training of Kazakh specialists engaged in the contractual works (paragraph 7 and 8 of Contract № 210, subparagraph 12) paragraph 1 Article 76 of the Subsoil Law);
- non-fulfillment of obligations for payment of past costs in the amount of 84,2 thousand Dollars (paragraph 3.5.1 of Addendum № 4 dated 28 January 2004, Addendum № 2543 dated 28 December 2007);
- admittance of unlicensed operation of trunk oil and gas pipelines (subparagraph 1) paragraph 1 Article 76 of the Subsoil Law;
- violation of obligations for procurement of goods, works and services (Article 77 of the Subsoil Law).

Under Contract № 305:

- non-submission of information on implementation of work programs (para 7.2.10 of Contract № 305, subparagraph 13) paragraph 1 Article 76 of Subsoil Law);
- non-fulfillment of obligations for training of Kazakh specialists (paragraph 9.3 License MG № 309-D dated 23 May 1997, paragraph 7.2.11 Contract № 305, subparagraph 12) paragraph 1 Article 76 of Subsoil Law);
- non-fulfillment of obligations for payment of past costs in the amount 114, 809 thousand US Dollar (Addendum № 6 dated 13 June 2008);
- non-fulfillment of obligations for effecting deductions to the abandonment fund

(paragraph 20.5 of Contract № 305);

- non-fulfillment of obligations for timely and full payment of taxes and other mandatory charges to the budget (subparagraph 16) paragraph 1 Article 76 of Subsoil Law);
- admittance of unlicensed operation of trunk oil and gas pipelines (subparagraph 1) paragraph 1 Article 76 of the Subsoil Law;
- violation of obligations for procurement of goods, works and services (Article 77 of the Subsoil Law).

Refusal of the Claimant to remedy violations of the contracts

- 31.21 Having partially acknowledged the violations “Tolkynneftegaz” LLP and “Kazpolmunay” LLP submitted only their explanations in respect of non-fulfilled obligations and refused to remove the violations of their obligations (see the Response of “Tolkynneftegaz” LLP ref. № 1341tng dated 19 July 2010 (**Exhibit C-26.2**) and Response of “Kazpolmunay” LLP ref. № 841kpm dated 19 July 2010 (**Exhibit C-24.2**)).
- 31.22 Comparative analysis of violated obligations which removal demanded the competent authority (according to Notices dated 14 July 2010) and explanations of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP (according to Responses dated 19 July 2010) is presented in the Table “Analysis of the grounds for termination of Contracts № 210 и № 305” (**Exhibit R-154**).
- 31.23 However, acknowledging the facts of non-performance of some of their obligations (primarily pecuniary) “Tolkynneftegaz” LLP and “Kazpolmunay” LLP refer in their explanations to the fact that they are not liable for these violations, since their non-performance was linked to force-majeure circumstances. Moreover they characterize attachment of their accounts under force-majeure circumstances. The circumstances specified by the Claimants (attachment of accounts) can not be ascribed to force-majeure circumstances, since they are not “inevitable and extraordinary circumstances”.¹⁵⁷ Quite to the contrary they have arisen by the will of a person and can be prevented in case of elimination of the grounds for attachments.
- 31.24 Acknowledgment by the Claimant of the fact of non-fulfillment of some of its obligations, in the absence of grounds to consider the reasons for their non-fulfillment as force-majeure, indicates that the Claimant does not contest the facts of such violations as such.

¹⁵⁷ Para. 2 Article 359 of the Cini Code RK contains a following definition of force-majeure circumstances: “A person who has failed to perform or has unduly performed an obligation when carrying out entrepreneurial activities, shall bear financial liability, unless he proves that proper performance turned out to be impossible as a result of force majeure, that is extraordinary and unavoidable events under given circumstances (natural calamities, military actions, etc.). In particular, lack in the market place of the goods, works or services which are required for the execution, shall not be referred to as such circumstances.” (**Exhibit R-8**) Similar definition of force-majeure circumstances is contained in Contracts № 210 и № 305”.

31.25 As a result the competent authority exercised the right provided for by the provisions of paragraph 3 Article 72 of the Subsoil Law to a unilateral termination of Contracts № 210 and № 305 having notified thereof “Tolkynneftegaz” LLP and “Kazpolmunay” LLP on 21 July 2010 (see Notice ref. № 20-05-5151 addressed to “Tolkynneftegaz” LLP (**Exhibit C-4**) and Notice ref. № 20-05-5150 addressed to “Kazpolmunay” LLP (**Exhibit C-2**)).

Concerning the alleged “groundlessness” of the notices

31.26 The Claimant’s references to groundlessness and unlawfulness of the Notices of the competent authority dated 14 July 2010 ref. № 14-05-4924 and ref. № 14-05-4923 (**Exhibits C-6 and C-2**) due to the fact that as of 14 July 2010 the competent authority (Ministry of Oil and Gas) had no results of the unscheduled inspection,¹⁵⁸ are not true.

31.27 In accordance with paragraph 8 Article 61 of the Subsoil Law the competent authority, the Ministry of Oil and gas, shall exercise **control** over the execution by subsoil users of the terms of the contracts for exploration, production, combined exploration and production.

31.28 In case of violation of the contract by the subsoil user the competent authority in its written notice shall indicate at the duty of the subsoil user to remedy such violation within the fixed period.

31.29 I.e., the violations of the terms of the contracts entailing notices are detected as a result of monitoring and control.

31.30 As the Claimant notes in accordance with paragraph 14 Article 38 of the Law of the Republic of Kazakhstan “On Private Entrepreneurship” as amended of 17 July 2009 (**Exhibit R-125**) based upon the result of the inspection an official of the state body performing the inspection shall draw up a report on the results of the inspection. In the opinion of the Contractor, the lack of the Report on the inspection results as of the date of the Notice of violation of obligations entails its illegality.

31.31 Meanwhile by the time of sending the Notices of violation of obligations the competent authority already was in possession of interim results of the inspection which revealed violations by the contractors of the contract terms (which were fixed in the Notices and upon inspection completion specified in the Reports on the inspection results).

31.32 According to paragraph 1 Article 37-1 Article 38 of the Law of the Republic of Kazakhstan “On Private Entrepreneurship” as amended of 17 July 2009 (**Exhibit R-125**) inspection of a subject of private entrepreneurship is **only one of the forms of state control**.

¹⁵⁸ See the Response of “Tolkynneftegaz” LLP ref. № 1341tng dated 19 July 2010 (**Exhibit C-26.2**) and Response of TOO “Kazpolmunay” ref. № 841kpm dated 19 July 2010 (**Exhibit C-24.2**)

- 31.33 At the same time under subsoil use contracts the competent authority carries out monitoring and control over the fulfillment by subsoil users of the terms of the contracts.
- 31.34 Thus, according to subparagraph 5) paragraph 1 Article 8 Article of the RK “On Subsoil and Subsoil Use” of 1996 in a version which was in effect prior to coming into force of the Law “On Subsoil” (**Exhibit R-20**), among the functions of the competent authority was monitoring and control over the fulfillment by subsoil users of the contract conditions including the obligations for Kazakh personnel content.
- 31.35 Monitoring and control structure, content and procedure shall be established by the Government of the Republic of Kazakhstan.
- 31.36 In particular such procedure was established by the Rules for conducting of monitoring and supervision over the compliance with fulfillment of the terms of subsoil use contracts approved by the Resolution of the Government of the Republic of Kazakhstan dated 1 October 2007 № 863-1 (hereinafter referred to as the Rules) (**Exhibit R-156**).
- 31.37 According to paragraphs 2, 3 of the Rules: (1) supervision over the compliance with fulfillment of the terms of subsoil use contracts includes the activity for securing the compliance by subsoil users with the terms of contracts; (2) monitoring over the compliance with fulfillment of the terms of subsoil use contracts shall comprise activities for gathering and generalisation of information on the progress of implementation by subsurface users of obligations under contracts, for the purposes of ensuring the compliance with the terms of contracts.
- 31.38 In line with paragraph 6 of the Rules, monitoring shall be conducted on the basis of (1) initial information presented by subsurface users in the form of reports, written explanations in relation to fulfillment of the terms of contracts and requirements of legislation when performing operations of subsurface use; (2) data of state bodies participating in the monitoring in accordance with the Law Concerning the Subsurface and (or) authorized in accordance with legislative acts to conduct state supervision over the compliance by subsurface users with requirements of the legislation of the Republic of Kazakhstan when performing operations of subsurface use.
- 31.39 According to paragraph 13 of the Rules all data of the monitoring, including those received from other state bodies, shall be entered by the competent body in the common information database — common state system of subsurface use monitoring of the Republic of Kazakhstan (EGSM NP).
- 31.40 In line with paragraph 15 of the Rules in **the course of supervision** the competent bodies shall perform **analysis of the monitoring data**, conduct **inspections** of subsurface users in terms of their compliance with the conditions of the contracts.

- 31.41 If the inspection reveals a fact of non-compliance by the subsurface user with the terms of the contract, the competent body shall undertake in relation to such a subsurface user measures in accordance with laws and provisions of the contract (paragraph 17 of the Rules).
- 31.42 **Violations by the companies “Tolkynneftegaz” and “Kazpolmunay” of the obligations specified in the Notices of the competent authority dated 14 July 2010 ref. № 14-05-4924 and ref. № 14-05-4923 (Exhibits C-6.2 and C-2.2) were detected by the competent authority as a result of permanent monitoring of the compliance by the subsurface users of their contractual obligations.**
- 31.43 The inspections of performance by “Tolkynneftegaz” LLP and “Kazpolmunay” LLP of their obligations were carried out on a regular basis. Within each inspection violations were detected, including those fixed in the Notices of 14 July 2010.
- 31.44 Therefore, the Claimant’s assertions to the effect that the companies “Tolkynneftegaz” and “Kazpolmunay” were never accused of any of the violations specified in the above mentioned Notices of 14 July 2010 (see paragraph 206) do not correspond the reality.
- 31.45 Thus, the lack of the Reports on the inspection results as of the date of sending the Notices does not entail illegality and groundlessness of such Notices, since violations had a permanent, continuing character.

Concerning the time period for removal of violations

- 31.46 The Claimant’s reference in paragraph 312 of the Statement of Claim to the fact that the time period fixed by the competent authority in the Notices of 14 July 2010 ref. № 14-05-4924 and ref. № 14-05-4923 (**Exhibits C-6.2 and C-2.2**) (three days) is the unreasonable amount of time to respond which constitutes a violation of due process”, is baseless.
- 31.47 Again the Claimant presents false data. In the Notices a five-day period is meant.
- 31.48 The legislation of the Republic of Kazakhstan does not establish the time period which the competent authority should grant to a subsoil user for solving the issue of elimination of obligations’ violations as well as does not regulate the procedure of determination of such time period.
- 31.49 Basing on provisions of subparagraph 1 paragraph 3 Article 72 of the Subsoil Law, the competent authority is entitled to independently determine the time period within which the subsoil user should remedy the violations of its obligations.
- 31.50 In case if there were no violations specified in the Notices a five-day period is deemed to suffice in order to submit to the competent authority the documents proving due performance of contractual obligations.

- 31.51 In their Responses to the Notices “Tolkynneftegaz” LLP and “Kazpolmunay” LLP (**Exhibits C-25.2, C-26.2 and C-24.2**) did not submit such documents which proves the existence of violations.
- 31.52 At the same time taking into account a **strategic role of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP** for the region’s economy (all produced gas is supplied to the JSC “MAEK-Kazatom” covering 80% of the demand of the power plant), numerous applications of the Akimat of the Mangystau region concerning aggravation of the production and financial status of TOO “Tolkynneftegas” and “Kazpolmunay” LLP entailing wage arrears towards employees of TOO “Tolkynneftegas” and TOO “Kazpolmunay”, information of the Ministry of Labour and Social Protection of the Republic of Kazakhstan on staff redundancy in connection with a sharp decrease in the volume of which could result in the social tension in the region, the competent authority did not have the possibility to grant to TOO “Tolkynneftegas” and “Kazpolmunay” LLP an extensive time period for submission of the response to the Notices, the aforesaid is confirmed by the letters of respective state bodies (**Exhibit R-158**).
- 31.53 Assertion of the Claimant about timeliness of submission of responses to the Notices is not true. The time period specified in the Notices for submission of explanations of the reasons for non-performance of the contract conditions (19 July 2010) was missed.
- 31.54 19 July 2010 is the date of registration of the Responses to the Notices by the secretariats of TOO “Tolkynneftegas” and “Kazpolmunay” LLP but not the date of their receipt by the Ministry of Oil and Gas. The evidence of receipt of these documents by the Ministry of Oil and Gas with indication of the date of their receipt was not submitted by the Claimant. Taking into account that the Notice sent by the Ministry of Oil and Gas on 14 July 2010 was received by “Tolkynneftegaz” LLP on 16 July 2010 (**Exhibit C-6.2**), hence the Responses sent by TOO “Tolkynneftegas” and “Kazpolmunay” LLP should have been received by the Ministry of Oil and Gas on 21 July 2010, i.e. on the second day after the expiry of the time (**Exhibit R-25.2 and C-26.2**).
- 31.55 Thus, contracts № 210 and № 305 were terminated on 21 July 2010 in full conformity with the provisions of the Subsoil Law.
- 31.56 Legal consequences of termination of Contracts № 210 and № 305

Requirement of performance of current obligations

- 31.57 In accordance with paragraph 25.6 of Contract № 210 (**Exhibit C-52**) and paragraph 30.7 of Contract № 305 (**Exhibit C-45**) TOO “Tolkynneftegas” and “Kazpolmunay” LLP were not released from performance of current obligations which remained not fulfilled by the moment of delivery of the notice to the Contractor of termination of the Contract, i.e. by 21 July 2010.

Transfer into trust management

- 31.58 As a result of the early termination by the competent authority of Contracts № 210 and № 305 in accordance with provisions of paragraph 10 Article 72 of the Subsoil Law contract areas were transferred into trust management and facilities and equipment securing the continuity of the process and industrial safety, - into a temporary possession and use by the national company – JSC NK “KazMunaiGaz” for a period prior to the transfer of property to a new subsoil user.
- 31.59 Transfer of the property of TOO “Tolkynneftegaz” and “Kazpolmunay” LLP into temporary possession and use to JSC NK “KazMunaiGaz” was caused by a number of reasons:
- (a) In line with paragraph 10 Article 72 of the Subsoil Law the property shall be transferred in order to secure the continuity of the process and industrial safety.
 - (b) The President of the Republic of Kazakhstan gave the instruction on the inadmissibility of production shutdown at the enterprises TOO “Tolkynneftegaz”, “Borankol Gas Treatment Plant”, TOO “Kazpolmunai”, TOO “KASKO” and the company “Caspian Gas Corporation”(Exhibit C-23).
 - (c) As was mentioned above in paragraph 13.3.4 of this Statement of Defence the production facilities of TOO “Tolkynneftegaz” and “Kazpolmunay” LLP have a strategic importance for the region. The entire volumes of produced gas supplied to the JSC “MAEK-Kazatom” covers 80% of the demand of the **nuclear power plant** which shutdown is fraught with the consequences in form of a technological disaster which may entail huge damage to national and ecological safety of the Republic of Kazakhstan and the whole Caspian region. Shutdown of production of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP could lead to formation of social tension in the region (Exhibit R-158).
- 31.60 At present the contract areas have not been transferred to anyone and are in the trust management of AO NK “KazMunaiGaz”. “Tolkynneftegaz” LLP and “Kazpolmunay” LLP have not forfeited the right to the assets securing continuity of technological process and industrial safety the right, they are in the temporary possession and use of AO NK “KazMunaiGaz”.
- 31.61 In all contracts of trust management between AO NK “KazMunaiGaz” and the Ministry of Oil and Gas of the RK it is clearly states that the trust management of AO NK “KazMunaiGaz” is provisional (till identification of a new subsoil user), whereby trust management does not entail the transfer of ownership to the objects of trust management in favour of AO NK “KazMunaiGaz”.
- 31.62 Thus, AO NK “KazMunaiGaz” is only an interim trust manager acting on behalf of the Ministry of Oil and Gas of the RK and has no right to sell the property of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP.

- 31.63 At present all money from the sale of products under the trust management contracts of the deposits Tolkyn and Borankol are accumulated in the special bank account (special account).
- 31.64 Besides basing on paragraph 2 Article 61 of the Subsoil Law former subsoil users have the right to a compensation of the cost of property, since in case of conclusion of the contract for a subsoil plot in respect of which the contract was already earlier terminated the contract with a new subsurface user must contain the obligation to reimburse the costs effected earlier by the former subsoil user, including the value of the transferred property in accordance with paragraph 10 of Article 72 of the Subsoil Law.
- 31.65 The lack of the fact of expropriation of the property of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP in favour of the state is also confirmed by the letters of state bodies carrying out administration of state property: 1) the letter of the Ministry of Finance of the Republic of Kazakhstan to which the Committee of State Property and Privatization belongs, dated 19 November 2011 № KGPI-5/16208 to the effect that no property of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP is recorded in the register of state property (**Exhibit R-160**); 2) the letter of the Akimat of the Mangystau region dated 23 September 2011 № 23-8-15/5858 that no property of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP is in the communal ownership (**Exhibit R-161**).

B Concerning termination of Contract № 302

Position of the Claimant

- 31.66 The Claimant stated that the Republic of Kazakhstan had wrongfully applied the Kazakh law having refused to “Tolkynneftegaz” LLP the extension of the exploration period under Contract № 302 having terminated it (see paragraphs 22, 217 of the Statement of Claim).
- 31.67 This Claimant's assertion is groundless and does not comply with the legislation of the Republic of Kazakhstan

Legislation of the Republic of Kazakhstan and termination of Contract № 302

Addendum to the Contract and requirement of introduction of amendments to the license

- 31.68 With its letter of 14 October 2008 № 2292 TOO “Tolkynneftegaz” applied to the Ministry of Energy and Mineral Resources (MEMR) for extension of the exploration period under Contract № 302 for 2 (two) years enclosing the Work Program for the requested extension period (**Exhibit C-67.2**).
- 31.69 With its letter of 24 March 2009 № 721T TOO “Tolkynneftegaz” applied to the MEMR for the inclusion of the issue of extension of the exploration period for 2 years into the agenda of the next meeting of the Expert Commission (**Exhibit R-162**).

- 31.70 According to the Minutes № 7 of the meeting of the Expert Commission of 2 April 2009 the Expert Commission passed the Decision – recommendation on extension of Contract № 302 for 2 years **(Exhibit R-163)**.
- 31.71 Notice №14-05-3160 of the adopted decision was sent to “Tolkynneftegaz” LLP on 9 April 2009 **(Exhibit C-27.2)**.
- 31.72 As was already mentioned earlier the decision of the Expert Commission had a character of recommendation.
- 31.73 Along with this decision the extension of the exploration period under Contract № 302 requires a number of legal actions in particular, introduction of amendments to Licence № 243-D (which follows from paragraph 27.5 of Contract № 302).
- 31.74 According to paragraph 27 of the Regulations on Subsoil Use Licensing in the Republic of Kazakhstan approved by the Resolution of the Government of the Republic of Kazakhstan on 16 August 1996 № 1017 (in force as of the moment of issuance of License № 243-D) the exploration license may be extended **if the licensee applied to the licensing authority for extension of the time period not later than 12 months (Exhibit R-164)**.
- 31.75 Subject to extension of the licence term the term and conditions of the contract shall be determined by the parties’ agreement in accordance with the license.¹⁵⁹
- 31.76 Thus extension of Contract № 302 should have been accomplished by way of introduction of amendments to Licence № 243-D, and thereafter – of respective amendments to Contract № 302.
- 31.77 If the term of the license was not extended, the contract term may not be extended.
- 31.78 Since TOO “Tolkynneftegaz” did not apply for extension of the term of Licence № 243-D the competent authority had no right to extend the term of Contract № 302.
- 31.79 Moreover it should be noted that “Tolkynneftegaz” LLP could not apply for extension of the mentioned licence. Since this license became void on the date of transformation of “Tolkynneftegaz” JSC into “Tolkynneftegaz” LLP, whereas a new license was not issued, i.e. “Tolkynneftegaz” LLP had no licence at all to carry out subsoil use operations.
- 31.80 Information about the practice of refusals by the competent authority to extend exploration period

¹⁵⁹ See Article 26 of the Decree of the President of the Republic of Kazakhstan which has the force of law dated 28 June 1995 № 2350 “On Oil” (hereinafter – Oil Decree) as in force on the moment of issuance of License № 243-D on which basis Contract № 302 was concluded.

31.81 Information about the practice of refusals to extend exploration period presented in the Fact Sheet of the Ministry of Oil and Gas of the Republic of Kazakhstan (**Exhibit R-165**) reveals that not all applications of subsoil users for extension of exploration periods are satisfied.

(a) In 2008 the competent authority received **152** applications for extension of exploration periods, **31** applications were refused.

(b) In 2009 the competent authority received **139** applications for extension of exploration periods, **38** applications were refused.

Right of a subsoil user to apply to court

31.82 In accordance with Article 9 of the Civil Code RK (**Exhibit R-8**) "Tolkynneftegaz" LLP was entitled to apply to judicial bodies for protection of the rights violated, in the Claimants' opinion, as a result of refusal to extend the exploration period under Contract № 302.

31.83 According to paragraph 2 Article 402 of the Civil Code RK "*The request to amend a contract may be filed by a party to the court only after the receipt of the refusal of the other party with regard to the proposal to amend the contract or in the case of failure to receive a response within the time period indicated in the proposal or established by legislation or the contract, and where it does not exist, - within thirty days time*" (**Exhibit R-8**).

31.84 Thus, "Tolkynneftegaz" LLP had the right to challenge in court of the Republic of Kazakhstan the actions of the competent authorities.

31.85 However "Tolkynneftegaz" LLP did not use this possibility.

Conclusion:

31.86 The Claimants' arguments of the unlawfulness of the refusal to "Tolkynneftegaz" LLP to extend the exploration period under Contract № 302 are groundless.

FURTHER ANALYSIS

31.87 At Section V of the Statement of Claim the Claimants allege that the Republic engaged in a last minute inspection "blitz". It is suggested that the Republic acted with the intention of seeking out unjustified breaches of contracts that it could use as a pretext for illegally seizing the Claimants' assets, namely the Contracts, the property and equipment, in order to effect what the Claimants allege was an act of direct expropriation.

31.88 The allegations are strenuously denied. In the most basic terms, there was no "seizure" of the Contracts or the Claimants' assets. The Contracts were terminated lawfully in accordance with legislation. KPM's and TNG's assets were taken into management in accordance with the law. This was done in accordance with the law, and on notice.

31.89 In summary:

- (a) TNG and KPM were already in breach of contract prior to July 2010 and therefore hardly needed to generate a further pre-text for terminating the contracts. Rather than remedying the situation, KPM and TNG simply fell further into breach.
- (b) In accordance with the laws of Kazakhstan, and pursuant to multiple notices by the Republic through its various ministries, the Republic investigated KPM's and TNG's compliance with their subsoil contracts.
- (c) As a result, the Republic identified further breaches of Contracts 210 and 305 and acted in accordance with the Subsoil Law and its contractual rights to terminate the Contracts.
- (d) Prior to commencing this so-called "seizure", the Claimants had completely abandoned their alleged investments. Anatolie Stati himself states that he instructed the remaining members of TNG and KPM management to leave Kazakhstan in early July 2010.¹⁶⁰ The Republic had no option but to invoke the trust mechanism under Kazakh law which enables the Republic to take control on a temporary basis of assets where they have been terminated and abandoned by the subsoil user.
- (e) Accordingly, the Republic acted in accordance with the law to take KPM's and TNG's property into the trust management of the competent authority, KMG.
- (f) Notwithstanding that such action was lawful, KPM and TNG had a number of opportunities to challenge the actions taken by the Republic, both under the Contract and in accordance with the law. They did not. KPM and TNG failed to utilise the mechanisms of law made available to them by the Republic. Instead, their alleged shareholders and interested parties (the Claimants) have characterised these events, which are, in reality contractual issues adequately dealt with by Kazakh law, as breaches of the ECT.
- (g) In effect, the Claimants used these events as a premise from which to launch a premeditated and unjustified attack on the Republic on the international stage, which they did, merely 5 days' later.
- (h) Since KMG has been in charge of KPM and TNG's assets, it has managed those assets in accordance with the law. In particular, any proceeds of production have been held in an escrow account.

(a) Continuing and persistent breaches of Contract

¹⁶⁰ Anatolie Stati, Witness Statement, paragraph 41.

(i) Existing breaches and wrongdoing by KPM and TNG

- 31.90 By July 2010, both TNG and KPM were in substantial breach of their contracts demonstrated potentially by three examples set out below. The factual basis of two of these examples was verified and checked (in some cases, twice) by the Republic's courts and those facts were used for the basis of findings that KPM, its General Director and TNG were guilty of crimes and civil law obligations. The facts supporting the third example are admitted by the Claimants in the Statement of Claim.
- 31.91 Firstly, KPM's General Director was found guilty of illegal entrepreneurship in respect of operating a main pipeline without the correct licence. (TNG's management had escaped full investigation of similar charges by fleeing the country and evading arrest.) Not only did this breach the Criminal Code as affirmatively concluded by two Kazakh courts, but, separately as would be expected, this was in breach of a number of provisions of the Contracts. For example, Contract 305 provides at clause 7.2.4 that KPM was obliged to "*Carry out Exploration and Production in strict accordance with the Legislation of the State and the Work Program.*"¹⁶¹
- 31.92 Secondly, it had been established that neither KPM nor TNG had been complying with tax legislation (misinforming the tax authorities and failing to pay the correct amount of taxes (or in the case of corporate back taxes, any monies whatsoever). This is contrary to article 12.1 of the TNG Contract and article 17 of the KPM Contract which both provide that: "*the Contractor pledges to pay taxes and other obligatory fees pursuant to Tax legislation of Republic of Kazakhstan...*"¹⁶²
- 31.93 Thirdly, as the Claimants themselves note in the Statement of Claim, by this point, TNG and KPM had been in breach of the Minimum Working Program for quite some time. The Minimum Working Program sets out the minimum volume of work and money that the subsoil user commits to investing in the licensed activity and the oil / gas field and as such, constitutes a fundamental component of the deal struck between the subsoil user and the hosting State. Under article 8 of the KPM Contract, KPM was obliged to "*carry out Exploration and Production in accordance with the Work Program agreed with the Competent Body*"¹⁶³ and article 7.6 of the TNG Contract, TNG is obliged to "*execute on its own risk the requirements of the Minimal Work Program state in p 8.3 of the Licence, during the validity of the Contract.*"¹⁶⁴ According to the Claimants' own assertions, in 2009 the Minimum Work Program in the KPM Contract indicated plans to drill eleven new wells in 2009. In fact, the Claimants assert, no wells were drilled. Similarly, in relation to the TNG Contract, the Minimum Work Program agreed to by TNG envisaged four new wells. In fact, the

¹⁶¹ Exhibit C-45¹⁶² Exhibits C-45 and C-52¹⁶³ Exhibit C-45¹⁶⁴ Exhibit C-52

Claimants assert, no wells were drilled.¹⁶⁵ In this context, it is disingenuous to assert, as the Claimants do at paragraph 209 of the SoC that “*there was no reason for the Ministry to claim that KPM and not complied with its work program requirements*” and accordingly this is denied.

31.94 As at July 2010, TNG and KPM had demonstrated that they were capable of breaching the Contracts. These were not minor breaches, but breaches that went to the root of the proprietary interest in Kazakhstan’s subsoil resources that had been granted to KPM and TNG in good faith by the Republic.

(ii) Notices for routine inspection

31.95 The Republic (for all the reasons set out elsewhere in this Statement of Defence), wished to ensure that KPM and TNG were acting in compliance with a wide range of laws. The relevant avenues of enquiry related to compliance with critical public legislation aimed at securing the safe and responsible running of oil and gas companies. It is admitted that a series of notices and orders pre-empted and notified the Claimants that further routine audits were due to ensure compliance with the terms of the Contracts. However, the Claimants have exaggerated the extent of the further enquiries.

31.96 Notices were issued to KPM and TNG on 25 January 2010 (on the basis of orders dated 22 and 25 January 2010) by the MEMR and 29 June 2010 (on the basis of decisions on 29 June 2010) by the General Prosecutor who gave notice to KPM and TNG that inspections would be carried out to ensure compliance with contractual obligations and compliance with legislation regarding subsoil use.¹⁶⁶ The purpose was not, as alleged at paragraph 199 of the Statement of Claim, to “*assess applicable legislation from the date each of the companies was established in 1997 to the present day*”.

31.97 Thereafter, in July 2010, ministries gave notice that inspections would take place regarding TNG’s and KPM’s compliance with labour laws,¹⁶⁷ environmental legislation,¹⁶⁸ subsoil laws (by the Geological committee and the Ministry of Oil and Gas),¹⁶⁹ industry and technology issues.¹⁷⁰

31.98 As to the Claimants’ allegations in paragraphs 200 to 205 of the Statement of Claim:

(a) There were not audits from a “*dozen*” ministries as asserted by the Claimants at paragraph 42 of Condarachi’s statement and paragraph 200. On the basis of the documents submitted by the Claimants themselves, only 5 ministries requested further inspections. The Republic’s actions were, at all times, proportionate.

¹⁶⁵ FTI Report, paragraph 8.13.

¹⁶⁶ Exhibits C-171 and C-174

¹⁶⁷ Exhibit C-177

¹⁶⁸ Exhibit C-182

¹⁶⁹ Exhibit C-181 and C-185

¹⁷⁰ Exhibit C-180 and C-181

- (b) Notably the Claimants refer to a notification from immigration authorities at paragraphs 200 and 201. The Claimants are put to proof that this related to further audits. According to Mr Stejar's own witness statement, he had already left Kazakhstan at this point.¹⁷¹
- (c) As to the assertion that the Ministry of Oil and Gas inspections covered the same issues covered 6 months before, this is not admitted.
- (d) The Claimants are put to proof that the Financial Police carried out further investigations on 4 July 2010 and are further put to proof that such investigation caused Stati to instruct the evacuation of "middle-management" of KPM.
- (e) The Claimants are requested to explain the relevance of the assertion that a visit was made to inspect the LPG Plant on 9 July 2010 (which is not admitted). Further the Claimants are requested to explain what, if any, is the significance of the request by the Governor for a Land Cruiser to be made available even though this was the subject of a previous seizure order. It appears that the only conclusion that can be drawn here is that the previous seizure order was not complied with.

31.99 As set out at Section 20 the Republic had the right to carry out audits under the Contracts and also under Kazakh Law, all of the audits (including those January and July 2010) were carried out in accordance with the provisions of the contracts and Kazakh law and were aimed at ensuring KPM and TNG with complying with their obligations as subsoil users.

31.100 In addition to the legislative and contractual powers set out in that section, the following legislation is relevant to the Claimants' submissions:

31.101 In accordance with Article 61 (8) of the Subsoil Law the competent authority, the Ministry of Oil and gas, shall exercise control over the execution by subsoil users of the terms of the contracts for exploration, production, combined exploration and production. In case of violation of the contract by the subsoil user the competent authority in its written notice shall indicate at the duty of the subsoil user to remedy such violation within the fixed period. I.e., the violations of the terms of the contracts entailing notices are detected as a result of monitoring and control.

31.102 According to Article 8(1)(5) Article of the RK "On Subsoil and Subsoil Use" of 1996 (Exhibit R-20), the competent authority was responsible for monitoring and control the fulfilment by subsoil users of the contract conditions including the obligations for Kazakh personnel content.

- (a) In particular, the Republic established the Rules for conducting of monitoring and supervision over the compliance with fulfilment of the terms of subsoil use contracts

¹⁷¹ Stejar, Witness Statement, paragraph 24.

approved by the Resolution of the Government of the Republic of Kazakhstan dated 1 October 2007 № 863-1 (hereinafter referred to as the Rules) (Exhibit R-156).

- (b) According to paragraph 2, 3 of the Rules: (1) supervision over the compliance with fulfilment of the terms of subsoil use contracts includes the activity for securing the compliance by subsoil users with the terms of contracts; (2) monitoring over the compliance with fulfilment of the terms of subsoil use contracts shall comprise activities for gathering and generalisation of information on the progress of implementation by subsurface users of obligations under contracts, for the purposes of ensuring the compliance with the terms of contracts.
- (c) In line with paragraph 6 of the Rules, monitoring shall be conducted on the basis of (1) initial information presented by subsurface users in the form of reports, written explanations in relation to fulfilment of the terms of contracts and requirements of legislation when performing operations of subsurface use; (2) data of state bodies participating in the monitoring in accordance with the Law Concerning the Subsurface and (or) authorized in accordance with legislative acts to conduct state supervision over the compliance by subsurface users with requirements of the legislation of the Republic of Kazakhstan when performing operations of subsurface use.
- (d) According to paragraph 13 of the Rules all data of the monitoring, including those received from other state bodies, shall be entered by the competent body in the common information database common state system of subsurface use monitoring of the Republic of Kazakhstan (EGSM NP).
- (e) In line with paragraph 15 of the Rules in the course of supervision the competent bodies shall perform analysis of the monitoring data, conduct inspections of subsurface users in terms of their compliance with the conditions of the contracts.
- (f) If the inspection reveals a fact of non-compliance by the subsurface user with the terms of the contract, the competent body shall undertake in relation to such a subsurface user measures in accordance with laws and provisions of the contract (paragraph 17 of the Rules).

(ii) Final inspections in July 2010

31.103 The final inspection that the various ministries carried out identified serious violations committed by TNG and KPM.

Final Inspection of TNG

31.104 As set out in the notices of breach that followed the inspection,¹⁷² the final inspection of TNG revealed the following breaches:

- non-submission of information regarding the execution of the working programs (paragraph 6.2.10 of the Contract No.210, subparagraph 13 of paragraph 1 of article 76 of the Subsoil Law¹⁷³);
- non-submission of the report annex on expenditure of funds for teaching of persons with indication of studying persons, list of educational programs, teaching organizations, dates of training(paragraph 6.2.13 of the Contract No.210);
- non-fulfilment of obligations of training Kazakh specialists engaged in the works under the contract (paragraphs 7 and 8 of the Contract No.210, subparagraph 12 of paragraph 1 of article 76 of the Subsoil Law¹⁷⁴);
- non-fulfilment of obligations of payment of historical expenses amounting to 84,2 thousand USD (paragraph 3.5.1 of Addendum Agreement No.4 of 28 January 2004, Addendum Agreement No. 2543 of 28 December 2007);
- operation of oil and gas mains without license (subparagraph 1 of paragraph 1 of article 76 of the Subsoil Law and in breach of a number of clauses of the contract as set out above);
- breaching obligation of purchase goods, works and services (article 77 of the Subsoil Law¹⁷⁵).

Final Inspection of KPM

31.105 As set out in the notices of breach that followed the inspection¹⁷⁶, the final inspection of KPM revealed the following breaches:

- non-submission of information regarding compliance with the working programs (paragraph 7.2.10 of the Contract No.305, subparagraph 13 of paragraph 1 of article 76 of the Subsoil Law);
- non-fulfilment of obligations to train Kazakh specialists (paragraph 9.3 of License MG No. 309-D of 23 May 1997, paragraph 7.2.11 of Contract No. 305, sub-paragraph 12) Article 76(1) of the Subsoil Law);
- failure to pay historical expenses amounting to 114,809 USD (Addendum Agreement No.6 of 13 June 2008);
- failure to contribute to the liquidation fund (paragraph 20.5 of the Contract No.305);
- non-fulfilment of obligations of timely and full payment of taxes and other obligatory

¹⁷² Exhibit C-6

¹⁷³ Exhibit R-152

¹⁷⁴ Exhibit R-152

¹⁷⁵ Exhibit R-152

¹⁷⁶ Exhibit C-2

payments to the budget (subparagraph 16 of paragraph 1 of article 76 of the Subsoil Law);

- unlicensed operation of oil and gas mains without license (subparagraph 1 of paragraph 1 of article 76 of the Subsoil Law and in breach of a number of clauses of the contract as set out above);
- breaching obligations regarding the purchase of goods, works and services (article 77 of Subsoil Law).

31.106 The broad range of breaches committed by KPM and TNG were of considerable concern to the Republic and added to the concerns that the Republic already had regarding the operation of KPM's and TNG's assets. Therefore, the inspections only confirmed the Republic's suspicions that KPM and TNG continued to be in breach of contract.

31.107 Accordingly, following the results of the final inspections and in addition to the other breaches identified during the course of its monitoring of KPM and TNG, the Republic issued breach notices on 14 July 2010 in respect of the Contracts as authorised by article 17 of Subsoil Law 2010.¹⁷⁷ These notices from the Ministry of Justice set out:

- (a) the contract to which the notice related;
- (b) the contractual breaches by KPM and TNG indicated above;
- (c) a time limit for responding within; and
- (d) the consequences of failing to respond to the notice, being termination in accordance with Article 3 of the Subsoil Law.

31.108 (As to paragraph 206, it is worth noting that the Claimants' description of the notices is incorrect as compared to its own translation of the document. Therefore, rather than referring, as the translation does to: "*Unlicensed operation of trunk oil and gas pipelines has been committed*", the Claimants state that "*KPM had admitted that it operated main oil and gas pipelines without a license*" stating that the this amounted to an "*obvious reference to the State's criminal action against KPM, itself falsely couched as an "admission" that KPM had operated "main" and oil gas pipeline [sic] without a license*". Notwithstanding that KPM did indeed make such an admission [cross-refer to admission section], this is a mis-characterisation of the translation.)

(iii) Kazakh law framework for termination of contracts

¹⁷⁷ Exhibits C-2 and C-6.

31.109 Under paragraph 17 of “The rules of monitoring and enforcement of the conditions of subsoil use contracts” of 1 October 2007 № 863-1 (Monitoring and Enforcement Rules)¹⁷⁸, if monitoring identifies that a subsoil user had not been complying with the terms and conditions of a contract, the competent authority (Ministry of Oil and Gas) is entitled to take measures against such user of mineral resources pursuant to Kazakh law and the provisions of the contract.

31.110 Accordingly, the Tribunal should be aware of the following provisions of Contracts 210 and 305 and Kazakh law that the Republic had regard to when terminating the Contracts in accordance with the Law of Republic of Kazakhstan “On subsoil and subsurface use” (**Subsoil Law**) (**Exhibit R-152**).

Subsoil Law 2010

31.111 The Subsoil Law enables the Republic to manage its subsoil resources and regulate relations arising out of subsoil operations. Chapter 6 deals with Subsoil Use Contracts themselves and, specifically, article 72 of Subsoil Law sets out the circumstances when a subsoil use contract can be terminated. The following paragraphs of Article 72 are particularly relevant to the termination of Contract 305 and 210.

- (a) Under paragraph 2 of Article 72, either party is entitled to terminate the contract in circumstances established by law:

“2. A contract may be prematurely terminated by agreement between the parties and on demand of either party in instances established by this Law.”

- (b) Article 72, paragraph 3 provides:

3. The competent authority may prematurely terminate a contract unilaterally in the following cases:

1) if the subsoil user fails to timely eliminate more than two violations of obligations under its subsoil use contract or project documents within the stated period of time;

2) in case of transfer of subsoil use right and/or objects associated with subsoil use right by subsoil user without permit of the competent authority as provided for by Paragraphs 1 and 3 of Article 36 of this Law, except for the cases when such consent is not required in accordance with Paragraph 5 of Article 36 of this Law.

¹⁷⁸ Exhibit R-156

A violation of contractual terms which the subsoil user fully eliminated within the period of time stated in the competent authority's notice shall not be a reason for a premature unilateral termination of the contract.

31.112 Accordingly, the Republic is entitled to terminate Contracts 210 and 305 where KPM and TNG in the following circumstances:

- (i) Where the subsoil user is in breach of two or more of its obligations; and
- (ii) where such breaches have not been not remedied;
- (iii) within the period of time allocated by the Republic.

31.113 There is no requirement that reasons be given for any termination under these provisions.

31.114 Therefore, a subsoil user faces the possibility of termination once it is in breach of two or more provisions of its contract, and the cure period is defined by the Republic.

31.115 Article 72(6) similarly entitles the executive body of a region in Kazakhstan to terminate the Contracts on similar grounds as those set out in paragraph 3 above:

“6. The executive body of a region (city of republican significance or capital city) may early terminate the contract for exploration or production of commonly occurring minerals unilaterally if the subsoil user fails to eliminate more than two violations of its contractual obligations or the obligations provided for in the project documents by the time indicated in written notices sent by the executive body of the region (city of republican significance or capital city) to the subsoil user.[...]

The violation of contractual terms and conditions which the subsoil user fully eliminated within the period of time stated in notices sent by the executive body of a region (city of republican significance or capital city) shall not be a reason for a premature unilateral termination of the contract.[...]

31.116 Such powers are additional and supplementary to any termination rights that the Republic is entitled to assert under the terms of the Contracts.

31.117 In accordance with paragraph 22.1 of Contract № 210 (Exhibit C-52) and paragraph 27.1 of Contract № 305 (Exhibit C-45) the mentioned contracts (as well as other agreements signed on the basis of the Contract) shall be governed by the law of the Republic of Kazakhstan.

31.118 As set out above, as soon as KPM and TNG had committed two or more breaches of the contracts, they risked termination by the Republic under the Subsoil Law and / or the Contract. Even before the final investigations in July 2010, the Republic would have been entitled to invoke its rights under Article 72(3). This was only more the case after July 2010.

31.119 In respect of paragraph 226 of the Statement of Claim, in referring to the call between Mr Calancea and Mr Organbaev on 22 July 2010, the Claimants note that Mr Calancea “asked whether the Ministry intended to comply with the contract terms, which required a 90 - day notice period in the event of the State’s unilateral termination in order for the termination to be effective.” It is unclear if any submission is made in respect of this point. However, such an observation is irrelevant since the Contracts were terminated under the Subsoil Law and not the Contracts. In any event, it is not admitted that the Contracts provide a 90-day notice period and the Claimants are put to proof in this respect.

(iv) Inadequate responses to the Republic’s notifications of breach

31.120 The Ministry of Oil and Gas requested that KPM and TNG provide a response to each of the notices by 19 July 2010, which should have presented the Republic with an explanation of the reasons for it not fulfilling the obligations and provide it with all necessary documents confirming that it would eliminate the breaches as well as to inform the Republic about measures it would take to avoid breaching the Contracts.¹⁷⁹

31.121 The Claimants’ responses on 19 July 2010 to the alleged breaches were inadequate and failed to address the violations revealed.¹⁸⁰ Having partially acknowledged the violations TOO “Tolkynneftegaz” and “Kazpolmunay” LLP submitted only their explanations in respect of non-fulfilled obligations and refused to remove the violations of their obligations THГ (see the Response of TOO “Tolkynneftegaz” THГ ref. № 1341tng dated 19 July 2010 (Exhibit C-i26.2) and Response of КПМТОО “Kazpolmunay” ref. № 841kpm dated 19 July 2010 (Exhibit C-j24.2)).

31.122 A comparative analysis of the obligations breached the elimination of which the competent body required (pursuant to the notifications as of 14 July 2010) and explanations of TNG and KPM (according to replies as of July 19, 2010) is given in the Table “Analysis of reasons for termination of Contracts No.210 and No.305” (**Exhibit R-154**). In particular, it can be seen from the Claimants’ responses and as further set out at paragraphs 209 to 215 of Statement of Claim, that:

- (a) In response to notice of KPM’s and TNG’s failure to fulfil its obligations relating to instruction and training of a Kazakh specialist (which was identified in relation to contract 305 and 210), neither company addressed the breach alleged by the notice. Instead KPM and TNG referred to funding it had allocated for training *all* their employees.
- (b) In response to notice of KPM’s failure to pay past costs pursuant to Additional Agreement no.6 dated 13 June 2008 of Contract 305, KPM simply denied that it should be liable to pay such costs for “force majeure” reasons arising out of the execution orders on its

¹⁷⁹ Exhibits C-2 and C-6

accounts. These execution orders only came about as a result of KPM failing to pay the fine it was required to as a consequence of the criminal proceedings referred to in paragraph [] above. KPM's own failure to comply with the court's order by repaying the fine cannot be considered as a force majeure under the Contract.

- (c) In response to notice of KPM's and TNG's failure to contribute to the liquidation funds, as required under Contract 305 and 210, both entities again attempted to justify this failure on the grounds of force majeure as a result of the execution orders on its assets. For the same reasons as set out in paragraph [b] above neither KPM's nor TNG's breach and failure to comply with the court's order by repaying the fine cannot be considered as an event of force majeure.
- (d) In response to notice of KPM's failure to pay taxes and other obligatory payments, as required under sub-item 16 p.1 art. 76 of Subsoil Law 2010, KPM again attempted to justify this failure on the grounds of force majeure as a result of the execution orders on its assets. For the same reasons as set out in paragraph [b] above KPM's failure to comply with the court's order by repaying the fine cannot be considered as an event of force majeure.
- (e) In response to notice of KPM's and TNG's illegal operation of trunk pipelines, in violation of sub-item 1 p.1 of Subsoil Law 2010, KPM and TNG attempted to re-open the debate, when the issue had already been conclusively settled in court as set out in Section 7 above. The failure to recognise these violations and take action to remedy them highlights the extent to which the Claimants were unwilling to engage with the Republic and the disregard that the Claimants had for the legitimate and lawful processes of the Republic.
- (f) In relation to the allegation by KPM and TNG that because the results of the final investigations were not issued until 15 July 2010 the Republic issued invalid notices under the Subsoil Law. In making this assertion, KPM and TNG rely on article 38 of the law "On Private Entrepreneurship"¹⁸¹ regarding the formalities to be addressed in carrying out investigations. It is not clear of what relevance this is to the validity of notices under the Subsoil Law. The Claimants are put to proof that there is any requirement in the Subsoil law that requires a notice to be given pursuant to an investigation. In any event, the Claimants are further put to proof that, if it is alleged to be the case, the Republic failed to comply with the law on "Private Enterprise" concerning investigations. KPM and TNG state in both their letters that *"the unscheduled inspection conducted by the*

¹⁸⁰ Exhibits C-24 and C-26

¹⁸¹ Exhibit R-125. According to paragraph 1 Article 37-1 of the Law of the Republic of Kazakhstan "On Private Entrepreneurship" as amended of 17 July 2009 (Exhibit R-125) inspection of a subject of private entrepreneurship is only one of the forms of state control.

Committee of Ministry of Oil and Gas was completed on 15.07.2010 with submission of the Act on the results of unscheduled inspection to LLP ["Tolkynftegaz"] ["Kazpolmunay"] on the same day".¹⁸² In the alternative, by the time of the notices were sent, the competent authority was already in possession of interim results of the inspection which revealed violations by the contractors of the contract terms (which were fixed in the Notices and upon inspection completion specified in the Reports on the inspection results) in accordance with article 38(14) of the Law of the Republic of Kazakhstan "On Private Entrepreneurship" as amended of 17 July 2009.

31.123 In essence, KPM and TNG failed to take full responsibility for their actions and instead the companies relied on three main reasons / tactics for rebutting the charges of breach validly made against them:

- (a) Avoiding the allegations set out;
- (b) Stating that issues of non-payment all relate to force majeure; and
- (c) Challenging the legality of the notices issued by the Ministry of Oil and Gas on procedural grounds.

31.124 As to each of these:

- (a) Failing to respond to an allegation is not a response. It is denied that KPM and TNG "*submitted detailed responses to each of the alleged violations*" as asserted in paragraph 209 of the Statement of Claim. Accordingly, the Claimants' comments in paragraph 210 are irrelevant.
- (b) Force majeure is a mechanism for protecting a contracting party where circumstances outside of its control affect its ability to comply with contractual performance. In other words, it is a contractually negotiated provision which excuses what would otherwise be a breach of contract by the contracting party. KPM's and TNG's assertion here is that because they failed to pay their taxes and moreover, in the case of KPM, it did not repay monies owed to the Republic accrued illegally, the companies are entitled to be exonerated of what are flagrant breaches of their contractual obligations. This position is simply untenable. The circumstances specified by the Claimant (attachment of accounts) can not be ascribed to force-majeure circumstances, since they are not "inevitable and extraordinary circumstances". Rather than establish that they are entitled to relief, the simply acknowledged that they do not contest as such, the facts as such.

¹⁸² Exhibits C-24 and C-26

(c) The notice provisions in the law were complied with. In any event, as any commercial party knows, the over-reliance on procedural notice provisions is a weak basis on which to argue that fundamental breaches by a contracting party should be exonerated. This is all the more so when there was no prejudice suffered by the failure to provide adequate notice.

31.125 As a result of these inadequate responses, it was clear to the Republic that KPM and TNG were not willing to accept that they had breached the contracts, nor were they going to make any attempts eliminate such breaches. These poor justifications have been adopted by the Claimants in the Statement of Claim.

31.126 The Claimants was therefore in clear breach of Article 72(3).

(v) Notice of the Termination of Contracts 210 and 305

31.127 Thus, as explained above, the inspections of TNG's and KPM's performance of their contractual obligations were carried out on a regular basis. Within each inspection violations were detected, including those fixed in the Notices of 14 July 2010. The Claimants are put to proof as to its assertion at paragraph 206 of the Statement of Claim, that TNG and KPM were never accused of any of the violations specified in the above mentioned Notices of 14 July 2010.

31.128 In view of the long-standing nature of TNG's and KPM's breaches and in accordance with the notices served under the relevant legislation, Republic terminated the Contracts.

31.129 The Republic sent notices to KPM and TNG on 21 July 2010, terminating Contracts 210 and 305 in accordance with Article 72(3) (**C-4 and C-2**). The notices were based on order no 255 by the Ministry of Oil and Gas that stated: *"In order not to allow prejudicing economic and ecological security of the state as well as social and political situation"*¹⁸³, Contract 305 and 210 were unilaterally terminated and it was ordered that under article 72(10) of the Subsoil Law transfer of buildings and equipment located on the contract territory *"into temporary possession and use"* was necessary *"to ensure a continuous production process and industrial safety."*¹⁸⁴ This had followed notification by the President of the Republic of Kazakhstan who had given an instruction that ceasing production at the enterprises TOO "Tolkynneftegaz", "Borankol Gas Treatment Plant", TOO "Kazpolmunai", TOO "KASKO" and the company "Caspian Gas Corporation" (**Exhibit C-23**) would have been impossible. The production facilities of TOO "Tolkynneftegas" and "Kazpolmunay" LLP have a strategic importance for the region. The entire volumes of produced gas supplied to the JSC "MAEK-Kazatom" covers 80% of the demand of the nuclear power plant which shutdown is fraught with the consequences in form of a technological disaster which may entail huge damage to national and ecological safety of the Republic of Kazakhstan and the

¹⁸³ C-189

whole Caspian region. Shutdown of production of “Tolkynneftegaz” LLP and “Kazpolmunay” LLP could lead to formation of social tension in the region (**Exhibit R-158**).

- 31.130 By way of these notices, KPM and TNG were informed that their facilities and equipment were to be transferred by the former subsoil user to the national company for temporary use and possession until the transfer of the property to a new subsoil user in accordance with 72(1) of the Subsoil Law. The notices stated that if the subsoil user failed to do this, the Ministry of Oil and Gas would be forced to act as a trust manager to the property.
- 31.131 As set out above, this was in accordance with the law since Article 72(3) of Subsoil Law 2010 does not provide a set period in which the Republic was required to allow KPM and TNG to provide a response to such a response. It was therefore for the Ministry of Oil and Gas to independently determine the length of time KPM and TNG had to reply.
- 31.132 The time period provided for in the notices was sufficient and the Claimants failed to reply.
- 31.133 In the alternative, to the extent that the Claimants allege that the Republic failed to comply with any notice periods it was required to under the Subsoil law, this is denied.
- 31.134 Further and in the alternative, it is the Republic’s position that the Claimants have suffered no prejudice from a failure to comply with such notice period. By this stage, there were no key personnel from KPM or TNG present to run the companies at this stage. Moreover, no substantial interference of the Claimants’ assets as a result of such an alleged failure to notify and therefore this is irrelevant. It is denied, as alleged in paragraph 209 of the Statement of Claim that such notice was “exceedingly short”.
- 31.135 In any case, 1.10 it is noted that TNG and KPM failed serve their responses in a timely manner. 19 July 2010 is the date of registration of the Responses to the notices by the secretariats of TNG and KPM but not the date of their receipt by the Ministry of Oil and Gas. The Claimants are put to proof in this respect since no evidence of receipt of these documents by the Ministry of Oil and Gas bearing the date of receipt was not submitted by the Claimant. Given that the Notice sent by the Ministry of Oil and Gas on 14 July 2010 was received by TNG, 16 July 2010 (Exhibit C-6), the Responses sent by TNG and KPM and should have been received by the Ministry of Oil and Gas on 21 July 2010 (**Exhibits C-25 and C-26**); thus the Claimants failed to comply with the notices.
- 31.136 As to the Contract 302:
- 31.137 It is admitted that as asserted by the Claimants at paragraph 197 and 198 of the Statement of Claim, a notice of breach was issued on 6 May 2010 stating that TNG had failed to comply with

¹⁸⁴ Exhibits C-189

the annual working program in respect of Contract 302 and a further letter was sent requesting that delays be “removed”.

- 31.138 It is also admitted that TNG’s compliance with Contract 302 was investigated as part of the July 2010 investigations. As with the Contract 210 and 305, the Republic notified TNG of the results of its investigations on 14 July 2010.¹⁸⁵
- 31.139 As the Claimants acknowledge at paragraph 198 of the Statement of Claim, Contract 302 had already come to an end on 30 March 2009 in accordance with the terms of the Contract. As the Claimants assert at paragraph 198 of the Statement of Claim and is accepted, “*TNG suspended its exploration operation in the Contract 302 Properties*” in 2009. The Claimants assert that the reason for this was “*so as not to be in breach of its obligations by conducting exploration activities without Ministry approval.*” However, the Claimants are put to proof that this is the reason that production stopped. [*Refer to FTI report giving other reasons for the ceasing of production in 2009 (not least its own cash flow issues?)*]
- 31.140 These letters were sent mistakenly and evidence a minor administrative error on the part of the Republic.
- 31.141 On 22 July 2010, in any event, TNG was given notice that Contract 302 had terminated on the grounds of its expiry.¹⁸⁶
- 31.142 In this respect and with reference to paragraph 216 of the Statement of Claim, it is difficult to see how an administrative error can constitute evidence that the Republic intended to use the issue of the pipeline to “*in an attempt to harm - and ultimately control - The Claimants ’ investments*”. The comment that the finding that the pipeline operation was illegal is contrary to the decisions and findings of other Governmental agencies is simply wrong has been dealt with elsewhere.
- 31.143 The position in respect of this contract was referred to in the call on 22 July 2010 when Mr Ongarbaev clarified that the order sent related to the contract cancellation due to its expiry and that, therefore, it differs slightly from the situation regarding Contracts 305 and 210 which were terminated for breach.

(B) Temporary Management of KPM’s and TNG’s property and equipment

- 31.144 The Claimants allege that the Republic seized the Claimants’ assets. This is a total mischaracterisation of what was in fact the lawful consequence of KPM’s and TNG’s own misbehaviour under the Contracts and unwillingness to co-operate.

¹⁸⁵ Exhibit C-7

¹⁸⁶ Exhibit C-5

- 31.145 Following the early termination by the Ministry of Oil and Gas of Contracts No. 210 and No. 305, the contractual territories were transferred into the trust management of the national company, KazMunaiGaz NC JSC, pursuant to paragraph 10 of Article 72 of the Subsoil Law 2010.
- 31.146 As highlighted previously, the Claimants had abandoned their investments and left the Republic to deal with the turmoil created. This can be seen as:
- (a) By July 2010 all of the senior and middle management had left the Republic on their own accord. Rather than face the responsibilities and address the Kazakh courts in relation to charges of a serious and criminal nature, they chose to be criminal fugitives of the Republic.
 - (b) There was a risk that as a result of this abandonment, without any management, the fields would have been poorly operated or stopped operating at all which could have led to a technological catastrophe and environmental damage on both a regional and national level.
 - (c) On a practical level, the subsoil area needed to be transferred into trust management to ensure that the fields continued operation. KPM's and TNG's employees were also offered the opportunity to join KMG to avoid the risk of considerable redundancies and social tension in the region.
- 31.147 The Republic expressly pointed out that the Article 72(10) of the Subsoil Law (**Exhibit R-152**) would be invoked in its termination notices to KPM and TNG so that the subsoil area would be transferred to KMG.

Transfer into trust management pursuant to Subsoil Law

- 31.148 This was in accordance with and envisaged by the law.
- (a) Paragraph 10 of Article 72 of the Subsoil Law (**Exhibit R-152**) provides:

*“10. If a contract is early terminated by the competent authority, the national company shall take the contract territory into its **trust management**. The former subsoil user's property, structures and equipment ensuring continuity of the process flow and industrial safety shall pass into temporary possession and use to the national company for the period until the property is transferred to a new subsoil user. If the former subsoil user is absent or evades transferring its property to the national company, then the national company shall act as the former subsoil user's attorney with respect to its property. The competent authority shall be obliged to put the subsoil area under the contract to tender or conduct direct negotiations.” [emphasis added]*

- (b) This trust management system is a critical tool for the proper management of subsoil contracts.
- (c) It should be noted that under paragraph 9 of Article 72 of the Subsoil Law (**Exhibit R-152**), termination of the contracts would not release the Claimants of their obligation to return the territories that they were licensed and contracted to use to the Republic:

“9. The termination of the contract shall not release the subsoil user from the obligations to relinquish the contract territory to the state and eliminate the consequences of its subsoil operations as required by the laws of the Republic of Kazakhstan.”

- (d) Once a new subsoil user is granted a contract to exploit the terminated territory, the contract is to contain a provision requiring the new subsoil user to compensate the previous subsoil user for its costs, including the costs of the property transferred in its favour, in accordance with Article 61(2) of Subsoil Law 2010:

“If a contract is concluded with respect to a subsoil area which contract was terminated a contract with a new subsoil user must contain obligations to compensate the previous subsoil user and a trust manager for costs, including the cost of property transferred under Paragraph 10 of Article 72 of this Law as well as the obligation to pay a free to the trust manager.”

31.149 Under the Subsoil law,

- (a) Article 73 of the Subsoil Law 2010 provides:

*“(1) **The grounds for reinstating contract for exploration and production.** The competent authority is entitled on its own initiative to reinstate the contract without the court's decision by reinstating the suspended/terminated and cancellation of its earlier decision to terminate/suspend where:*

1) the decision to suspend was based on incorrect information

2) the breach by contractor was outside of its control

(2) The grounds for review of its decision- shall be application by the contractor or authority's own review within 6 months of the initial decision

(3) The decision on reinstatement should be taken within 1 month after the application by the contractor (where this is the ground for review)

(4) There contract is reinstated on the initiative of the authority, the parties shall within 3 months conclude a supplemental agreement which should regulate the reinstatement and

issues re the suspension/ responsibilities. The deadline may be extended by competent authority.

(5) The decision on reinstatement should be communicated to the contractor within 10 working days and shall be sufficient ground for the contractor to resume operations until execution of the supplemental agreement”

31.150 Therefore, the Subsoil Law provides for the following mechanism:

- (a) In the event of termination, the territories under Contracts 210 and 305 shall be transferred to national company (KazMunaiGas) to hold in trust management.
- (b) The concept of "trust management" should not be mistaken for the "trust" system utilised in, for example, the English legal system. As distinct from trust arrangements, relations on "trust management" under the Subsoil law are of an obligatory character. Furthermore, a "trust manager" can not be regarded as a "trustee" since property is transferred to him on a temporary basis in possession and use, however, legally it continues to be regarded as a property of the owner. The owner of the property after transfer of property into trust management continues to be liable for its property under its obligations.
- (c) The provision also allows for all of KPM's and TNG's property, structures and equipment which are needed to ensure continuity and production and industrial safety to be transferred to KazMunaiGas until these assets are eventually transferred to a new subsoil user.
- (d) If the Claimants through KPM and TNG either refuse to transfer such property or are absent at the time of such transfer, KazMunaiGas is entitled to act as its attorney in order to effect the transfer.
- (e) The subsoil user is entitled to "appeal" the decision to terminate the contract on certain grounds.
 - (i) if Contracts 210 and 305 were terminated by a decision of the Ministry of Oil and Gas (as the 'competent authority') of the Republic, then KPM and TNG can apply to have the decision reviewed if it was based on incorrect information or the breach was out of its control;
 - (ii) The Ministry of Oil and Gas then have 1 month to make a decision on reinstatement and a further 10 days to communicate any decision to reinstate the contract;

- (iii) If the contract is reinstated the parties have a further 3 months to conclude a supplemental agreement to regulate the reinstatement. However, in the meantime, the subsoil user can resume its operations;
- (iv) The intention behind this Article was to encourage subsoil users to engage with the Republic even after termination of the contracts in order to resolve the issue and reinstate the terminated contracts.
- (f) The appeal process (which is initiated at the subsoil users' choice and is not a court-based process) can take some months and as it is envisaged that negotiations will take place between the subsoil user and the Ministry of Oil and Gas.
- (g) During any appeal process under Article 73, in accordance with Article 72(10) of the Subsoil Law (**Exhibit R-152**), the contracted territory is to be held in trust management.
- (h) Thus, the trust management provision was not only a mechanism to protect the contracted territories, but it also implicitly enabled the negotiations envisaged by Article 73 to take place.¹⁸⁷
- (i) As such it is important to recognise that no transfer of title is envisaged under the scheme. The competent authority merely has a right to possess and use until reinstatement to the owner or transfer of title to another subsoil user.
- (j) According to Article 61(2) of the Subsoil Law former subsoil users have the right to a compensation of the cost of property, since in case of conclusion of the contract for a subsoil plot in respect of which the contract was already earlier terminated the contract with a new subsurface user must contain the obligation to reimburse the costs effected earlier by the former subsoil user, including the value of the transferred property in accordance with paragraph 10 of Article 72 of the Subsoil Law (**Exhibit R-152**).

31.151 On 21 July 2010, pursuant to the legislation, the Ministry of Oil and Gas and KMG agreed two trust management agreements over the subsoil areas for the Tolkyn and Borankol. These transferred the subsoil areas to KMG as the areas were no longer contracted to KPM and TNG as a result of the termination of the **Contracts only (Exhibit R)**. The transfer was in accordance with the first part of Article 72(10) of the Subsoil Law (**Exhibit R-152**):

“If a contract is early terminated by the competent authority, the national company shall take the contract territory into its trust management.”

¹⁸⁷ At present the competent authority is holding negotiations with subsoil users on the out-of-court renewal of the subsoil use contracts terminated earlier at its initiative (**Exhibit R-153**).

31.152 In relation to the LPG Plant, the Claimants had abandoned the plant in May 2009, well before the Contracts were terminated. The LPG Plant was never part of the property that was transferred to KMG on trust management and therefore it still remains the property of TNG.

31.153 Next, KMG set up a working for taking Tolkyn and Borankol fields subsoil areas for trust management by KMG, pursuant to order #216 dated 21.07.2010 (**Exhibit R-203**).

KPM's and TNG's refusal to partake in a consensual process for transferring property and instead prematurely commencing international arbitration proceedings

31.154 There was nothing preventing KPM and TNG from voluntarily handing over the property following the invocation of the trust mechanism. Indeed, the transfer of such property, structures and equipment was intended to be a consensual process under Article 72(10) of the Subsoil Law (**Exhibit R-152**) with the previous subsoil user agreeing to the process, in accordance with Article 72(10) of the Subsoil Law, in the knowledge that it could either:

- (a) Engage with the Republic in order to resolve the issues in accordance with the appeal process provided in Article 73; or
- (b) If it does not wish to take this co-operative approach, there was provision for it to be compensated for the property transferred to a new subsoil user in accordance with Article 61.

31.155 Indeed in a call between Mr. Calancea of TNG, Mr. Ongarbaev of the Ministry of Oil and Gas and Mr. Utigaliev (deputy head of KMG's working group for the fields in accordance with KMG Order 216), all the issues of the termination of the Contracts were discussed in a cordial manner. As to the content of the call:

- (i) Mr Ongarbaev demonstrated that TNG was informed that there was a clear procedure under Kazakh law for the termination of subsoil use contracts and the transfer of property into trust management.
- (ii) TNG was informed that the primary concern of the whole process was to ensure continuity of oil and gas production and maintain social ambience in the region, which as mentioned above, was a particular concern for the Republic given that it the Claimants had abandoned their assets.
- (iii) The process was designed to be consensual, with property being transferred to the trust management company KMG at the consent of the Claimants in the knowledge that they could either engage with the Republic to resolve the issues or be compensated for the property transfer. The Claimants had indicated that they would consent to that procedure by requesting a draft of the substitution agreement.

- (iv) After the Contracts were terminated any production carried out by KPM and TNG on the subsoil area would obviously be illegal from 22 July 2010 onwards. The Republic was only trying to warn the companies that this was the case and therefore the need to ensure the efficiency of a property transfer.

31.156 Rather than engaging in this process in accordance with the Kazakh legislative regime, TNG and KPM made their position quite clear in correspondence shortly after the terminations on 24 July 2010 (**Exhibit C-193 and C-194**) when they stated that *“TNG/KPM has not and is not going to transfer anything, including the facilities and equipment requested by you, to KMG”* (**Exhibit C-194 and C-195**), They purporting to rely on provisions of the contract to assert that *“in the event of termination of the Contract, the Contractor is entitled to independently manage the property which is in his ownership.”* (**Exhibit C-194 and C-195**). This statement was clearly disingenuous given the fact that there was in fact no-one to manage the companies, hence why the Republic was forced to invoke the trust management mechanism in the first place.

31.157 Accordingly, despite being given the opportunity to engage with the Republic, TNG and KPM refused to sign or even engage with the discussions with the Republic in relation to the draft substitution agreement that was sent to the Claimants. (**Exhibit R-200**: Agreements relating to draft property use numbered agreement 199-26 and 200-26 each of 21 July 2010) The Claimants have stated that the *“terms were unacceptable”* (para 230 of the SoC) without providing any explanation of why this was the case.

31.158 In fact by 26 July 2010, the Claimants had already submitted its Request for Arbitration to the SCC, only 5 days after the Republic repudiated Contracts 305 and 210, which made apparent that it:

- (a) had no interest in recovering its assets using the mechanisms it was afforded under Kazakh law;
- (b) was only concerned with trying to obtain artificially high compensation under the ECT for its property by concocting a story that the Republic had expropriated its investment, which, for the reasons set out in Sections 14 and 15 above, in reality had little value; and
- (c) knew all along that any compensation it would receive from a new subsoil user for its assets after a termination would reflect the actual low value.

31.159 Turning again to the law, as set out in Article 72(10) of the Subsoil Law (**Exhibit R-152**):

“If the former subsoil user is absent or evades transferring its property to the national company, then the national company shall act as the former subsoil user’s attorney with respect to its property.”

31.160 As a result of the lack of co-operation by the Claimants and that decision to commence arbitration proceedings, on 28 July 2010 the Republic had no option but to employ the attorney provisions set out in Article 72(10) of the Subsoil Law (**Exhibit R-152**) and arrange for an agreement to be entered into for the transfer of the property to KMG (see Ministry of Oil and Gas and KMG ## 1-DVV-UVS//204-26 and 2- DVV-UVS //203-26 dated 28 July 2010 (**Exhibit R-201 and R-202**)). This was necessary in order to:

- (a) To protect the subsoil and environment and keep the property in a state suitable for it being used in future for its designated purpose;
- (b) Ensure there was continuity of flow of production in the contract area transferred for trust management. The assets were needed to ensure this continuity;
- (c) Avoid social tension in the region which would have resulted if the fields could not operate without the property as there would have been employee layoffs; and
- (d) Ensure that the property was maintained after it had been completely abandoned by the Claimants.

31.161 This was all done in accordance with Kazakh law.

(C) KMG's current trust management of the assets

31.162 Since being taken into trust management, KMG has delegated all of its immediate functions for subsoil area trust management to the Aktau branch of its 100% affiliate KazMunaiTeniz JSC (**KMT**) to allow it to temporarily conduct the trust management functions of running business (see KMG and KMT ## 217-10//04-103-2010 and 218-10//04-104-2010 dated 6 August 2010, (**Exhibits R-204 and R-205**)). KMT is only holding the property in trust management and therefore is not enjoying "full ownership" as asserted by the Claimants in paragraph 237 of the SoC. In fact, the Republic does not enjoy any ownership over the assets since no title has passed to the Republic or KMG under the trust arrangement scheme. This clear from:

- (a) Letter No. KGIP-5/16208 of 19 September 2011 of the Ministry of Finance of the Republic of Kazakhstan, which does not include any of the Claimants' former assets in Kazakhstan in State's Property Register (**Exhibit R-160**);
- (b) Letter No. 23-8-15/5858 of 23 September 2011 from the Akim of the Mangystau Oblast Region which provides that KPM's and TNG's property is not in communal property (**Exhibit R-161**).

31.163 At present the pipeline of TOO "Kazpolmunay" which is in temporary possession and use of the trust manager of the Borankol contractual area— a branch of JSC Offshore Oil Company

“KazMunayTeniz” –is being operated on the basis of the license obtained by the trust manager (**Exhibit R-136**).

- 31.164 KMT has to pay all proceeds they receive from production to an escrow account. The escrow account is operated such that:
- (a) Thus, KMG is only an interim trust manager acting on behalf of the Ministry of Oil and Gas of the RK and has no right to sell the property of TNG and KPM.
 - (b) Neither KMT nor KMG derive any benefit from being a trust management other than a small fee.
 - (c) In accordance with Additional Agreements #1 (**Exhibit R-195 and R-198**) to the trust management agreements (**Exhibit R-194 and 197**) between KMG and the Ministry of Oil and Gas (signed on 23.12.2010) only taxes and other obligatory payments to the state budget are paid directly from the escrow account.
 - (d) In accordance with section 5 of the trust management agreements the expenses that KMT incurs in connection with trust management activity are to be reimbursed to the extent of their actual costs (proved by documentary evidence) by using the income from the trust management activity. These trust management expenses need to be approved by an independent auditing firm and will only be reimbursed on that basis.
 - (e) Additional Agreement #2 (**Exhibit R-196 and R-199**) to the trust management agreements between KMG and Ministry of Oil and Gas dated on 03.05.2011 sets the procedure for auditing trust management related costs and reimbursing these costs. In accordance with Additional Agreement #2, the costs of using an independent auditing firm is to be funded by the escrow account.
 - (f) There has therefore been no investment in the territories since they have been held in trust management and production levels have continued the trend of decline (from 2008 onwards) since KPM and TNG abandoned the property.
- 31.165 Notwithstanding this, the Claimants / TNG / KPM have shown no interest in protecting the LPG Plant since the contracts have been terminated. KazMunaiTeniz have therefore been forced to employ guards to protect the Plant and re-employ those who were working at the plant to avoid social tension.
- 31.166 Article 72(10) of the Subsoil Law (**Exhibit R-152**) provides that the contractual territories are to be held in trust management until a transfer to a new user of mineral resources. As a result of the Claimants commencing these arbitration proceedings the Republic has been restricted from transferring these contractual territories to a new subsoil user. This has effectively hindered the process for the Claimants being compensated by a new subsoil user for the cost of its property in

accordance with Subsoil Law 2010. Furthermore, contrary to the Claimants' assertions, the Republic has derived no benefit from this process and it is only in the interests of the Republic for these issues to now be resolved (without any further delay) so that a new subsoil user can start investing in the fields.

D Avenues for recourse and premature reference to arbitration

31.167 The Contracts were terminated in accordance with the law, and the assets of KPM and TNG were taken into trust management to deal with a situation that had been created by TNG and KPM's breaches of contract and subsequent lack of engagement with the Republic.

31.168 Both the contracts and the Subsoil Law provide avenues for recourse where a subsoil user considers that its contract has been wrongfully terminated.

31.169 Under the KPM Contract, article 28 provides:

"28.1 The Parties shall take all measures to resolve all disputes and differences arising from the Contract through negotiations.

28.2 If any dispute cannot be resolved through negotiations within 30 days from the time it arises, the parties shall refer the dispute for its resolution to: The Arbitration Institute of the International Chamber of Commerce in Stockholm."¹⁸⁸

31.170 Under the TNG Contract article 23 provides:

"23.1 Parties do their utmost to resolve disagreements and disputes arising under or in connection with this Contract by negotiations.

23.2 If within 120 (one hundred twenty) days of the moment of the dispute arising it cannot be settled by negotiations, Parties shall address the dispute for its resolution to:

1. juridical bodies of Republic authorized as per Legislation to consider (examine) such disputes;

2. international arbitration bodies according to the law of Republic "On foreign investments".¹⁸⁹

31.171 As set out above, article 73 sets out an appeal procedure that was available to the Claimants for reinstating the contracts.

31.172 Termination under the Subsoil Law differs slightly from contractual termination and, since there is a non-court based appeal process available, it does not have the same level of finality as a

¹⁸⁸ KPM's Subsoil Use Contract, Article 28, **Exhibit C-45**.

¹⁸⁹ TNG's Subsoil Use Contract, Article 23, **Exhibit C-52**.

termination of a contract from a civil law perspective. The intention behind Articles 72 and 73 of the Subsoil Law (**Exhibit R-152**) was to induce a subsoil user to remedy any contractual breaches it had committed and to fulfil the requirements of the Kazakh Law. A subsoil user can use the mechanisms it is afforded under Kazakh law to engage with the Republic to either remedy its breaches and/or appeal any decision made if it believes that the decision was incorrect or the breaches were out of its control. This can all be done outside of the formal court and/or arbitration process.

- 31.173 Whilst the Republic was entitled to terminate these contracts, Article 73 provided a statutory mechanism for KPM and TNG to appeal the termination. The Claimants could have utilised this mechanism to engage in discussions with the Ministry of Oil and Gas on either of the grounds set out in Article 73(1) above. If it had utilised this mechanism it could have had almost a year to agree terms which would have reinstated contracts 210 and 305.
- 31.174 Instead of doing this, the Claimants failed to engage with the Republic. It was clear from its 19 July 2010 responses to the 14 July 2010 notices that it was simply not interested in reinstating contracts 210 and 305. The speed with which it commenced arbitration (only days after the termination on 26 July 2010) only further serves to prove that it had no interest in retaining its investments. They were happy to instead launch an unjustified attack on the Republic on the international stage without engaging with the Republic and seeking to exhaust their local law remedies.
- 31.175 Pursuant to paragraph 25.6 of Contract No. 210 and paragraph 30.7 of Contract No. 305, TNG and KPM were not relieved of their current obligations, which remained outstanding as at the date of the service of the termination notice on 21 July 2010.
- 31.176 Instead, the Claimants rushed to international arbitration, filing a Request for Arbitration 5 days following the termination of the Contracts.
- 31.177 The level of detail in the Claimants' Request for Arbitration (40 pages in length) makes a mockery of its claims that the Republic's actions were pre-meditated in 18 above. The Claimants had clearly devised a plan to bring an extortionate claim in the international stage against the Republic, well before the Contracts were terminated. For the reasons set out in paragraph 19.26 above, the Claimants' reference to a letter from the MEMR as evidence that the Republic "*knowingly engaged in its illegal scheme to effect the final takeover of the Claimants' investments*" (paragraph 233 of the SoC) is both incorrect and misleading and should in no way be considered as evidence that the Republic's actions were premeditated.

31.178 It seems hard to understand how the Claimants can credibly assert, as they do in paragraph 223 of the Statement of Claim that early termination came as a “*shock*”.¹⁹⁰

32 No breach of the ECT

32.1 As set out below, the Claimants have failed to establish that the Republic is responsible for any breach of the ECT.

32.2 In making its submissions as to law in Section 33 below, the Republic relies on and reasserts all the evidence set out in the Statement of Defence and in particular as set out in Section 17 to 31 of the Statement of Defence.

33 Expropriation

33.1 The Claimants suggest that the Republic expropriated the Claimants assets first indirectly through various actions to the Claimants’ disadvantage and then directly. Both parts of this allegation are denied.

33.2 The Republic understands the Claimants’ direct expropriation claims to be based on the alleged expropriation of assets held by KPM and TNG. In particular, the Claimants allege that the Republic, on 21-22 July 2010, directly expropriated KPM’s and TNG’s Subsoil Use Contracts by way of terminating these contracts. Further, the Claimants argue that the Republic directly expropriated KPM’s and TNG’s assets by seizing legal and physical control.¹⁹¹ Under Article 13(3) ECT, it is possible for the Claimants to rely on an expropriation of assets of KPM and TNG.

33.3 In contrast, with regard to indirect expropriation, the Claimants seem to argue that they themselves were expropriated, and that what was indirectly taken from them were their investments, namely KPM and TNG.¹⁹²

33.4 Article 13 ECT provides:

“(1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as “Expropriation”) except where such Expropriation is:

(a) for a purpose which is in the public interest;

(b) not discriminatory;

¹⁹⁰ Paragraph 233 of the Statement of Claim.

¹⁹¹ SoC, paras. 246, 253.

¹⁹² SoC, paragraph 270.

(c) carried out under due process of law; and

(d) accompanied by the payment of prompt, adequate and effective compensation.

Such compensation shall amount to the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way as to affect the value of the Investment (hereinafter referred to as the "Valuation Date"). [...]

(3) For the avoidance of doubt, Expropriation shall include situations where a Contracting Party expropriates the assets of a company or enterprise in its Area in which an Investor of any other Contracting Party has an Investment, including through the ownership of shares."

- 33.5 The Republic will structure its defence in four parts. First, the Republic will show that any claim of direct or indirect expropriation must fail because the Claimants did not pursue all available remedies. Second, the Republic will demonstrate that it did not directly expropriate KPM's and TNG's contracts or other assets. Third, the Republic will establish that there was no indirect expropriation of the Claimants. The fourth and last part will address the fact that if any expropriation occurred (which is denied) it was legal.

The Claimants' failure to pursue available remedies hinders the success of any expropriation claim

- 33.6 The Claimants' expropriation arguments fail in their entirety because the Claimants did not pursue all remedies available to them against the Republic's actions. With regard to each and every one of the Republic's actions, KPM and TNG could have turned either to contractually agreed arbitral tribunals or to the Republic's domestic courts. KPM and TNG either did not do so, or, if they did, they failed to pursue the available appeals against the courts' decisions. This fact alone bars any claim of expropriation.

(a) The requirement to pursue available remedies

- 33.7 Investment tribunals have frequently recognised that an expropriation of contractual rights is not perfected unless an investor had the opportunity to address the host State's actions in a contractually agreed forum but did not do so.

- 33.8 The tribunal in *Waste Management* was firm on this point:

"[T]he normal response by an investor faced with a breach of contract by its governmental counter-party (the breach not taking the form of an exercise of governmental prerogative, such as a legislative decree) is to sue in the appropriate court to remedy the breach. It is only where such access is legally or practically

foreclosed that the breach could amount to an definitive denial of the right (i.e., the effective taking of the chose in action) and the protection of [the expropriation clause of NAFTA] be called into play.

*Non-compliance by a government with contractual obligations is not the same thing as, or equivalent or tantamount to, an expropriation. In the present case the Claimant did not lose its contractual rights, **which it was free to pursue before the contractually chosen forum.** The law of breach of contract is not secreted in the interstices of [the expropriation clause of NAFTA]. Rather **it is necessary to show an effective repudiation of the right, unredressed by any remedies available to the Claimant, which has the effect of preventing its exercise entirely or to a substantial extent.**"¹⁹³*

- 33.9 The tribunal in *Parkerings v. Lithuania*¹⁹⁴ took the same position. This *Parkerings* case involved a contract between the city of Vilnius and an investor regarding the construction and maintenance of parking facilities.¹⁹⁵ The contract in question provided for resolution of disputes arising from the contract in the courts of Lithuania but the investor never turned to these courts.¹⁹⁶ In the words of the tribunal:

*"Second, a breach of contract, if there should be one is, in itself, not always sufficient to amount to an indirect expropriation within the meaning of the BIT. An investor faced with a breach of an agreement by the State counter-party should, as a general rule, **sue that party in the appropriate forum to remedy the breach.** Therefore, [...] a preliminary determination of the existence of a contractual breach under domestic law is, in most cases, a prerequisite.*

If the investor is deprived, legally or practically, of the possibility to seek a remedy before the appropriate domestic court, then the Arbitral Tribunal might decide on the basis of the BIT if international rights have been violated [...] That would be the case, for instance, if a party is denied the possibility to complain about the wrongful termination of the agreement before the forum contractually chosen. [...]

It is not the mission of the present Arbitral Tribunal to decide on the alleged breach of the Agreement, entered into by a company which acted as vehicle of the investment of the Claimant. In the absence of any objective reason not to bring the case before national

¹⁹³ *Waste Management, Inc. v. United Mexican States* (Number 2), ICSID Case No. ARB(AF)/00/3, Final Award, 30 April 2004, paras. 174 et seq. (emphasis provided) (**Exhibit C-234**).

¹⁹⁴ *Parkerings-Compagniet AS v. Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007 (**Exhibit R-1**).

¹⁹⁵ *Ibid.*, para. 82.

¹⁹⁶ *Ibid.*, para. 82.

¹⁹⁶ *Ibid.*, paragraph 318.

*tribunals, it cannot be concluded, on the basis of the facts at hand, that the Claimant's investment has been indirectly expropriated.*¹⁹⁷

- 33.10 Thus, as long as the investor has not pursued the available remedies to address the alleged contract breach - such as the alleged wrongful termination of the contract -, an expropriation of the contractual rights cannot have occurred.¹⁹⁸
- 33.11 This principle is not limited to breaches of contract alone but extends to breaches of domestic law as well. If the host State provides effective remedies for the assertion of breaches of domestic law, an expropriation is excluded as long as the investor's attempts in pursuing these remedies have not yet failed.
- 33.12 This position was firmly taken by the tribunal in *Generation Ukraine v. Ukraine*. The claimant in this case argued that Ukraine's "*local authorities obstructed and interfered with the realisation of that project over the course of [...] six years in a manner which was tantamount to expropriation*".¹⁹⁹ This argument was rejected by the tribunal with specific reference to the remedies that had been available to the claimant but had not been pursued:

*"The fact that an investment has become worthless obviously does not mean that there was an act of expropriation; investment always entails risk. Nor is it sufficient for the disappointed investor to point to some governmental initiative, or inaction, which might have contributed to his ill fortune. Yet again, **it is not enough for an investor to seize upon an act of maladministration, no matter how low the level of the relevant governmental authority; to abandon his investment without any effort at overturning the administrative fault; and thus to claim an international delict on the theory that there had been an uncompensated virtual expropriation. In such instances, an international tribunal may deem that **the failure to seek redress from national authorities disqualifies the international claim, not because there is a requirement of exhaustion of local remedies but because the very reality of conduct tantamount to expropriation is doubtful in the absence of a reasonable - not necessarily exhaustive - effort by the investor to obtain correction.*****"²⁰⁰

- 33.13 The *Generation Ukraine* tribunal expanded on this position when it further stated:

"This Tribunal does not exercise the function of an administrative review body to ensure that municipal agencies perform their tasks diligently, conscientiously or efficiently. That function is within the proper domain of domestic courts and tribunals that are cognisant of

¹⁹⁷ Ibid., paras. 448 et seq., 454 (emphasis provided).

¹⁹⁸ Cf. also *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/02/6, Jurisdiction, 29 January 2004, paragraph 161 (**Exhibit C-282**).

¹⁹⁹ *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003, paragraph 1.2 (**Exhibit R-2**).

²⁰⁰ *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003, paragraph 20.30 (**Exhibit R-2**) (emphasis provided).

*the minutiae of the applicable regulatory regime. In the circumstances of this case, the conduct cited by the Claimant was never challenged before the domestic courts of Ukraine. More precisely, the Claimant did not attempt to compel the Kyiv City State Administration to rectify the alleged omissions in its administrative management of the Parkview Project by instituting proceedings in the Ukrainian courts. There is, of course, no formal obligation upon the Claimant to exhaust local remedies before resorting to ICSID arbitration pursuant to the BIT. Nevertheless, **in the absence of any per se violation of the BIT discernable from the relevant conduct of the Kyiv City State Administration, the only possibility in this case for the series of complaints relating to highly technical matters of Ukrainian planning law to be transformed into a BIT violation would have been for the Claimant to be denied justice before the Ukrainian courts in a bona fide attempt to resolve these technical matters.***²⁰¹

- 33.14 Support for this position came from the tribunal in *EnCana v. Ecuador*. This tribunal had to deal with a decision of the Ecuadorian tax authority to no longer grant certain tax benefits previously granted based on provisions of Ecuadorian tax law. For the tribunal, it was clear that the absence of an attempt at pursuing domestic remedies present an expropriation of the tax benefits could not be found:

*“[T]here is [...] a difference between a questionable position taken by the executive in relation to a matter governed by the local law and a definitive determination contrary to law. **In terms of the BIT the executive is entitled to take a position in relation to claims put forward by individuals, even if that position may turn out to be wrong in law, provided it does so in good faith and stands ready to defend its position before the courts.** Like private parties, governments do not repudiate obligations merely by contesting their existence. An executive agency does not expropriate the value represented by a statutory obligation to make a payment or refund by mere refusal to pay, provided at least that (a) the refusal is not merely wilful, (b) the courts are open to the aggrieved private party, (c) the courts’ decisions are not themselves overridden or repudiated by the State.”*²⁰²

- 33.15 To sum up, there have been several reasons that have lead tribunals to consider a failure to pursue available remedies fatal to an expropriation claim:

- (a) Non-performance of a contract - and thus also termination of a contract - does not amount to an expropriation of the rights stemming from the contract as long as the loss of the right is not final, i.e. ultimately determined by the appropriate forum.

²⁰¹ *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003, paragraph 20.33 (**Exhibit R-2**) (emphasis provided).

²⁰² *EnCana Corporation v. Republic of Ecuador*, LCIA Case No. UN3481, Award, 3 February 2006, paragraph 194 (**Exhibit R-14**) (emphasis provided).

- (b) An act of maladministration at the lowest level cannot amount to an expropriation. Otherwise, investors could invoke any minor mistake at the local level and bring investment arbitration claims.
- (c) Tribunals generally are less knowledgeable about domestic law than domestic courts. Thus, in the absence of a valid reason for a failure to bring the claim to the appropriate forum, such failure puts into doubt that a right was actually taken from the investor.

(i) Remedies available to the Claimants

33.16 The Claimants could have put all of the Republic's actions they complain of before contractually agreed arbitral tribunals or before the Republic's courts. The Claimants either did not do so or did not pursue their claims through all available instances. This is fatal to their claim.

(ii) The Republic's contract related actions

33.17 As to the Republic's contract related actions: For a start, the Claimants invoke the termination of the Subsoil Use Contracts as an event of direct expropriation²⁰³ Moreover, the Claimants argue that the refusal to prolong Contract No. 302,²⁰⁴ the termination of Contract No. 302,²⁰⁵ the Republic's alleged refusal to apply contractually agreed amortization rates leading to an assessment of back taxes and penalties of USD 69 million,²⁰⁶ the alleged non-application of a contractually agreed exemption to the Crude Oil Export Tax²⁰⁷ and the alleged revocation of the Republic's purported approval of the transfer of TNG to Terra Raf²⁰⁸ all form part of an indirect expropriation. All of these claims fail for the simple reason that in each and every case, the Claimants could and should have pursued these claims by way of arbitration, as agreed in the Subsoil Use Contracts and Contract No. 302.

33.18 Art. 28 of KPM's Subsoil Use Contract provides:

"28.1 The Parties shall take all measures to resolve all disputes and differences arising from the Contract through negotiations.

28.2 If any dispute cannot be resolved through negotiations within 30 days from the time it arises, the parties shall refer the dispute for its resolution to: The Arbitration Institute of the International Chamber of Commerce in Stockholm."²⁰⁹

33.19 Likewise, Art. 23 of TNG's Subsoil Use Contract stipulates:

²⁰³ SoC, paragraph 253.

²⁰⁴ SoC, paragraph 271, 273.

²⁰⁵ SoC, paragraph 273.

²⁰⁶ SoC, paragraph 275.

²⁰⁷ SoC, paragraph 277.

²⁰⁸ SoC, paragraph 276.

²⁰⁹ KPM's Subsoil Use Contract, Article 28, **Exhibit C-45** (emphasis in the original).

“23.1 Parties do their utmost to resolve disagreements and disputes arising under or in connection with this Contract by negotiations.

23.2 If within 120 (one hundred twenty) days of the moment of the dispute arising it cannot be settled by negotiations, Parties shall address the dispute for its resolution to:

- 1. juridical bodies of Republic authorized as per Legislation to consider (examine) such disputes;*
- 2. international arbitration bodies according to the law of Republic “On foreign investments”²¹⁰.*

33.20 Finally, Art. 23 of Contract No. 302 states:

“23.1 The Parties do their utmost to resolve all disputes and disagreements arising out of the Contract by negotiations.

23.2 If the dispute cannot be resolved by negotiations within 30 days from its occurrence, the Parties shall refer it for resolution to:

- 1. the courts of the Republic authorized as per Legislation to examine such disputes;*
- 2. international arbitration in accordance with the Law of the Republic “On foreign investments”²¹¹.*

33.21 As can be seen, the arbitration clauses in TNG’s Subsoil Use Contract and in Contract No. 302 refer to the Republic’s Law on Foreign Investments. This law provides in its Article 27 (**Excluding P-210**) the following arbitration clause:

“Article 27. Settlement of disputes

- 1. Investment Disputes shall, if possible, be settled amicably.*
- 2. If such disputes cannot be settled amicably within a period of three months from the date of written request by one of the parties of the dispute to the other side, the dispute may be referred for resolution, if there is the written agreement of the foreign investor:*

- 1) into the Judicial Authorities of the Republic of Kazakhstan*
- 2) in accordance with an agreed procedure for settlement of disputes, in particular, that established by the contract or any other agreement between the parties in dispute, into one of the following arbitration bodies:*

- a) the International Centre for the Settlement of Investment Disputes (henceforth, the Centre), created in accordance with the Convention for the Settlement of Investment Disputes Between States and Citizens of Any Other States, open for signing in Washington, from the 18th March*

²¹⁰ TNG’s Subsoil Use Contract, Article 23, **Exhibit C-52**.

²¹¹ Contract No. 302, Article 23, **Exhibit C-53**.

1965 (Convention ICSID), provided the state of the investor is a signatory to that Convention;

b) the Auxiliary Establishment of the Centre (operating under the Auxiliary Agency Rules), where the investor's state is not a signatory of the ICSID Convention;

c) arbitration bodies established in accordance with the United Nations Commission for International Trade Arbitration Law (UNCITRAL) provisions;

d) for arbitration consideration, into the Arbitration Institute of the International Chamber of Commerce in Stockholm;

e) the Arbitration Commission of the Chamber of Commerce and Industry of the Republic of Kazakhstan.

3. In the event that a foreign investor decides on the procedure for consideration of disputes as provided for by sub-paragraph 2) of paragraph 2 of this Article, the consent of the Republic of Kazakhstan shall be presumed to have been granted. Consent of a foreign investor may be issued at any time by way of a written notice to an authorised state body or at the moment of petitioning for arbitration.

[...]

7. Disputes of foreign investors with citizens and legal entities of the Republic of Kazakhstan, including with the state bodies of the Republic of Kazakhstan which are not recognised as investment disputes shall be settled by the Republic of Kazakhstan judicial bodies in accordance with the Republic of Kazakhstan legislative acts, unless it is otherwise provided for by legislative acts or agreements of parties.”

33.22 Thus, for all of the Claimants’ contract-related claims, there was an effective remedy available. Instead of having KPM and TNG pursue this remedy, the Claimants instead first did nothing, and then, only five days after the Republic terminated the contracts, initiated the investment arbitration under the ECT.

(iii) The Republic’s other actions

33.23 The Claimants’ other, not contract-related claims fare no better. In this regard, the Claimants invoke the taking into trust management and taking physical control of KPM’s and TNG’s assets (as a direct expropriation),²¹² the assessment of USD 6 million in back “transfer” price taxes and penalties,²¹³ the initiation of bankruptcy proceedings against KPM,²¹⁴ the allegedly incorrect classification of KPM’s and TNG’s pipelines as trunk pipelines,²¹⁵ the trial and conviction of Mr.

²¹² SoC, paragraph 253.

²¹³ SoC, paragraph 274.

²¹⁴ SoC, paragraph 275.

²¹⁵ SoC, paragraph 279.

Cornegruta, the verdict against KPM²¹⁶ as well as the seizure orders against KPM's and TNG's assets of 30 April and 15 May 2009 and other execution measures²¹⁷ (all as part of an indirect expropriation).

- 33.24 All of these allegations could and should have been addressed in the domestic courts which were open to the Claimants in this regard. The Claimants only turned to the Republic's courts to a limited extent and in no case did the Claimants pursue all available appeals against lower-instance decisions.
- 33.25 However since nothing appears to have gone to the Supreme Court (which can go so far as to hear a challenge to a government decree) arguably there was still room for them to go further. Certainly the Claimants do not say they were denied the right of further appeal.
- 33.26 In light of the Claimants' failures and in light of the general approach of investment tribunals, all of the Claimants' expropriation claims must fail.

34 Direct expropriation

- 34.1 As set out above, the Claimants allege direct expropriations of assets of KPM and TNG due to the termination of the Subsoil Use Contracts and Contract No. 302 and due to the taking into trust management of KPM's and TNG's assets. Both allegations fail.
- 34.2 Direct expropriation describes a situation in which there is "*a forced transfer of property from the investor to the State, or a State-mandated beneficiary.*"²¹⁸
- 34.3 Transfer of title to the State or a third party nominated by the State is thus the decisive element for distinguishing direct and indirect expropriation. As was stated by the tribunal in *Sempra v. Argentina*:
- "The Tribunal does not in fact believe that there can be a direct form of expropriation if at least some essential component of the property right has not been transferred to a different beneficiary, in particular the State."*²¹⁹
- 34.4 The Claimants have invoked the case of *Santa Elena v. Costa Rica*²²⁰ for the proposition that "formal transfer of title is not a prerequisite for a formal or direct expropriation".²²¹ This reflects a clearly incorrect understanding of the award. The *Santa Elena* tribunal merely explained the

²¹⁶ SoC, paragraph 280.

²¹⁷ SoC, paras. 281 et seq., 284.

²¹⁸ Newcombe/Paradell, *Law and Practice of Investment Treaties: Standards of Treatment*, p.339 (**Exhibit R-60**).

²¹⁹ *Sempra Energy International v. The Argentine Republic*, ICSID Case No. ARB/02/16, Award, 28 September 2007, paragraph 280 (Award annulled on separate grounds) (**Exhibit C-263**).

²²⁰ *Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award, 17 February 2000 (**Exhibit C-213**).

²²¹ SoC, paragraph 251, referring to *Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award, 17 February 2000, paras. 76-81 (**Exhibit C-213**).

principles of expropriation in general and affirmed what is generally agreed in international law, namely that in some cases, an expropriation can occur without a formal transfer of title.²²² In making this statement, the tribunal did not differentiate between the concepts of direct and indirect expropriation and it certainly never stated that “formal transfer of title is not a prerequisite for a formal or direct expropriation”. It is hence clear that the tribunal was implicitly referring to indirect expropriations, not to direct ones.²²³

(b) Alleged expropriation of KPM’s and TNG’s other assets

- 34.5 The Republic further did not directly expropriate KPM’s and TNG’s other assets. Upon termination of the Subsoil Use Contracts, the ownership rights of KPM and TNG automatically ceased to exist. Under Article 72(10) of the Subsoil Law (**Exhibit R-152**) and due to the circumstances set out in detail above, the assets then had to be transferred to KMG so that they would be taken into trust management.
- 34.6 As explained above, and unlike in certain common law national jurisdictions, this does not entail any transfer of the title of the assets, although, under the provisions of the law, the trust manager is entitled to possess and use the facilities and equipment. This arrangement is set up so as to enable continuing production.
- 34.7 Therefore, there is no transfer of title envisaged under article 72(10) of the Subsoil Law. Moreover, the subsoil user has the opportunity to have its contract reinstate. Where this is not possible or desired, the contract can be transferred to a new subsoil user with the assets. At this point, the payment of the subsoil users’ costs and its property must be provided for in the new agreement.
- 34.8 This does not amount to an expropriation. Rather, an inherent limitation in the rights held by KPM and TNG came to bear. Moreover, there are opportunities for compensation within provided for within the mechanism.
- 34.9 In any event, it must again be reiterated that the Claimants could have turned to the courts of the Republic to address this issue. The Claimants failed to take advantage of the mechanisms set out for it in the Subsoil Law or the Contract. This fact in itself excludes any notion of expropriation.²²⁴

²²² *Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award, 17 February 2000, paragraph 76 (**Exhibit C-213**).

²²³ Likewise, Claimants reference to *Wena Hotels v. Egypt at SoC*, paragraph 252, fn. 463 is equally inapposite. The *Wena Hotels* tribunal equally did not specify whether it was addressing a case of direct or indirect expropriation. Under the general understanding of international law, it is however clear that the case was one of indirect expropriation, cf. *Wena Hotels Ltd. v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, Award on Merits, 8 December 2000, paras. 96 et seqq (**Exhibit C-216**).

²²⁴ See section 33.6.

34.10 In addition, a finding of direct expropriation is further excluded because the Republic in assuming control over KPM's and TNG's assets merely used its regulatory powers. Such legitimate regulation cannot be deemed a compensable taking.

34.11 In international law, it has long been recognised that even in cases of clear transfer of title, there is not always an expropriation. States, as part of their sovereignty, may take certain measures without being obliged to compensate investors. As the *S.D. Myers* tribunal stated:

*“The general body of precedent usually does not treat regulatory action as amounting to expropriation. Regulatory conduct by public authorities is unlikely to be the subject of legitimate complaint under [the expropriation provision of NAFTA], although the Tribunal does not rule out that possibility.”*²²⁵

Already the 1961 Harvard Draft recognised various reasons under which property may be taken without compensation:

*“An uncompensated taking of an alien property or a deprivation of the use or enjoyment of property of an alien which results from the execution of tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health or morality; or from the valid exercise of belligerent rights or otherwise **incidental to the normal operation of the laws of the State shall not be considered wrongful.**”*²²⁶

34.12 Presently, the Republic's authorities in taking control of KPM's and TNG's assets and in transferring them into trust acted in accordance with the Subsoil Law 2010. As mentioned above, the purpose of this law is to balance the host State's legitimate interest in furthering the wealth and well-being of its population and the investor's legitimate interest in making a return on its investment.²²⁷ By way of the Subsoil Law 2010, the Republic ensures in particular that investors cannot take over the gas and oil production on a certain field forever but that production rights are tied to contracts which expire and have to be renegotiated regularly.²²⁸ At the same time, the Subsoil Law 2010 also ensures that in case a contract with an investor expires, production does not come to a halt. By mandating that the assets of the former contractor are taken into trust and then issued to the new contractor, continuous production for the greater wealth of the Republic's population is ensured.

²²⁵ S.D. Myers, Inc. v. Canada, First Partial Award, 13 November 2000, paragraph 281 (**Exhibit C-287**).

²²⁶ Draft Convention on the International Responsibility of States for Injuries to Aliens (“Harvard Draft”), (emphasis provided) as quoted by Newcombe/Paradell, *The Law and Practice of Investment Treaties*, at p.328 (**Exhibit R-60**).

²²⁷ Cf. supra paragraph 31. See also Article 4 of Subsoil Law 2010 (Purpose and objectives of subsoil use legislation)

²²⁸ See Article 69 of Subsoil Law 2010 (Validity term of the Contract)

- 34.13 Naturally, any actions under the Subsoil Law 2010 are thus regulatory in nature. They serve a valid purpose within the public order of the Republic. In no way could they be deemed to be expropriatory.

35 Indirect expropriation

- 35.1 the Claimants' indirect expropriation claim likewise fails.

(a) Requirements for an indirect expropriation

- 35.2 Indirect expropriation describes a situation in which no transfer of title occurs but the host State's measures nonetheless are "tantamount" to expropriation or have an equivalent effect.²²⁹ Findings of indirect expropriation have only been made in a handful of cases so far.²³⁰
- 35.3 There is general agreement that the main criterion for a finding of indirect expropriation is the effect a governmental measure has on the rights of the investor. The tribunal in *Tecmed v. Mexico* gave a particular instructive description of the effects government conduct must have so that it can amount to an indirect expropriation:

*"To establish whether the Resolution is a measure equivalent to an expropriation under the terms of section 5(1) of the [Spain/Mexico BIT], it must be first determined if the Claimant, due to the Resolution, was **radically deprived of the economical use and enjoyment of its investments**, as if the rights related thereto —such as the income or benefits related to the Landfill or to its exploitation— had ceased to exist. In other words, if due to the actions of the Respondent, the assets involved have lost their value or economic use for their holder and the extent of the loss. [...]*

*[M]easures adopted by a State, whether regulatory or not, are an indirect de facto expropriation if they are **irreversible and permanent** and if the assets or rights subject to such measure have been affected in such a way that **"...any form of exploitation thereof..." has disappeared; i.e. the economic value of the use, enjoyment or disposition of the assets or rights affected by the administrative action or decision have been neutralized or destroyed.**"²³¹*

- 35.4 Later tribunals have regularly agreed with the approach in *Tecmed*.²³²

²²⁹ The Republic insofar agrees with Claimants' submissions in the SoC, paras. 259 et seq.

²³⁰ Newcombe/Paradell, *Law and Practice of Investment Treaties: Standards of Treatment*, p.345 (**Exhibit R-60**).

²³¹ *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID Case No. ARB (AF)/00/2, Award, 29 May 2003, paragraph 115 (emphasis provided) (**Exhibit C-209**).

²³² Cf. *Glamis Gold, Ltd. v. The United States of America*, Award, 8 June 2009, paragraph 357; (**Exhibit R-36**)

Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic, ICSID Case No. ARB/97/3, Award, 20 August 2007, paragraph 7.5.12. (**Exhibit C-253**)

- 35.5 At the same time, tribunals have been firm that even in cases such as described by *Tecmed*, there is not always an indirect expropriation. As already mentioned above, a State's right to regulate (also called a State's "police powers") can set limits to the requirement of compensating investors.²³³ "[T]he maintenance of public order, health or morality" and "the valid exercise of belligerent rights" may exclude expropriation; likewise, losses incurred by the investor "incidental to the normal operation of the laws of the State" may be non-compensable.²³⁴
- 35.6 Obviously, it may be difficult to ascertain which cases fall into the category of an indirect expropriation and which are a mere exercise of a host State's right to regulate. The solution must be found on a case by case basis,²³⁵ with several criteria playing a role. In particular, tribunals have looked at the proportionality of a host State's conduct, i.e. its effects on the investor compared to the harm the government seeks to address.

- 35.7 As the tribunal in *LG&E* stated:

*"With respect to the power of the State to adopt its policies, it can generally be said that the State has the right to adopt measures having a social or general welfare purpose. In such a case, the measure must be accepted without any imposition of liability, except in cases where the State's action is obviously disproportionate to the need being addressed."*²³⁶

- 35.8 The tribunal in *Tecmed* specified the approach to proportionality in the following way:

*"[T]he Arbitral Tribunal will consider, in order to determine if they are to be characterized as expropriatory, **whether such actions or measures are proportional** to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality. Although the analysis starts at the **due deference** owing to the State when defining the issues that affect its public policy or the interests of society as a whole, as well as the actions that will be implemented to protect such values, such situation does not prevent the Arbitral Tribunal, without thereby questioning such due deference, from examining the actions of the State in light of [the expropriation provision of the BIT] to determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation. **There must be a reasonable relationship of proportionality***

²³³

²³⁴ Draft Convention on the International Responsibility of States for Injuries to Aliens ("Harvard Draft"), ... (emphasis provided) as quoted by Newcombe/Paradell, *The Law and Practice of Investment Treaties*, at p.328 (**Exhibit R-60**).

²³⁵ Cf. Newcombe/Paradell, *Law and Practice of Investment Treaties: Standards of Treatment*, p.359 (**Exhibit R-60**).

²³⁶ *LG&E v. Argentina*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, paragraph 195. (**Exhibit R-63**)

between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.²³⁷

- 35.9 Other tribunals have formulated further requirements for the host State's right to regulate, namely due process of law and non-discrimination.²³⁸
- 35.10 Another consideration relevant to indirect expropriation stems from the fact that the Claimants have not complained (and in fact cannot complain) of any of the laws of the Republic being expropriatory. However, if the laws of the Republic themselves are not expropriatory, the logical conclusion is that only a misapplication of the laws can lead to an expropriation. Hence, a showing of lawfulness under domestic law excludes any notion of expropriation.

(b) No indirect expropriation in the present case

- 35.11 According to the Claimants, several actions of the Republic individually and cumulatively amount to an indirect expropriation of the Claimants' rights in KPM and TNG.²³⁹ In particular, the Claimants complain of the Republic's refusal to prolong the exploration rights under Contract No. 302,²⁴⁰ the assessment of back transfer price taxes and back taxes on corporate income,²⁴¹ the alleged revocation of the purported approval of the transfer of TNG's shares to Terra Raf,²⁴² the dispute about the application of the Crude Oil Export Tax,²⁴³ the classification of KPM's and TNG's pipelines as trunk pipelines,²⁴⁴ the ensuing trial and conviction of Mr. Cornegruta and the verdict against KPM²⁴⁵ and the seizure orders against KPM and TNG.²⁴⁶
- 35.12 In the view of the Claimants, these actions lead to the Claimants being deprived of the ability to "operate, control, enjoy, or sell KPM and TNG".²⁴⁷ the Claimants contend that in particular the alleged revocation of the purported approval of the transfer of TNG's shares to Terra Raf consumed "an extraordinary amount of time, attention and resources" and that the trial of Mr. Cornegruta caused other managers of KPM and TNG to "flee" the country.²⁴⁸
- 35.13 the Claimants' arguments suffer from two fatal flaws:

(i) Right to regulate

²³⁷ Técnicas Medioambientales Tecmed, S.A. v. United Mexican States, ICSID Case No. ARB (AF)/00/2, Award, 29 May 2003, paragraph 122 (**Exhibit C-209**).

²³⁸ Cf. Methanex v. United States, Final Award, 3 August 2005, Part IV, Chapter D., paragraph 7. (**Exhibit R-64**)

²³⁹ SoC, paragraph 285.

²⁴⁰ SoC, paragraph 273.

²⁴¹ SoC, paragraph 274 et seq.

²⁴² SoC, paragraph 276.

²⁴³ SoC, paragraph 277.

²⁴⁴ SoC, paragraph 279.

²⁴⁵ SoC, paragraph 280.

²⁴⁶ SoC, paragraph 281.

²⁴⁷ SoC, paragraph 272.

²⁴⁸ SoC, paras. 276, 283.

- 35.14 Most importantly, the Claimants fail to take into account their own poor and often illegal management of KPM and TNG. KPM and TNG repeatedly broke Kazakh law, in that they made incorrect tax assessments and operated a trunk pipeline without a licence. The Republic's audit requests were reasonable given the strong suspicions of wrongdoing. Thus, it was the Claimants' own fault that the authorities started investigations. If it were indeed true that these investigations affected the daily routine of the companies, the Claimants have only themselves to blame.
- 35.15 In that regard, the Republic was perfectly entitled to its actions because these actions had regulatory character and were aimed at protecting the rule of law and the public order. The Republic's right to regulate thus prevails and no expropriation can be found. In particular, the Republic's actions were proportionate. Given the Claimants' own unlawful conduct, it is absurd that the Claimants should point to any alleged harm done to them. It was the Claimants that were doing harm to the Republic and the Republic's acts were the proportionate reaction thereto.
- 35.16 Additionally, as set out above, the Republic always acted in accordance with its domestic law. As explained,²⁴⁹ this alone means that there can be no expropriation.
- 35.17 In particular, the trial and conviction of Mr. Cornegruta does not amount to an indirect expropriation. Again, this is first and foremost due to the fact that the Republic merely exercised its regulatory powers. As was held by the Aktau City Court and the Mangystau Regional Court, Mr. Cornegruta had committed a crime and thus was lawfully sentenced to a term of imprisonment.²⁵⁰ The Claimants cannot seriously argue that a lawful criminal conviction can be cause for a duty to compensate under international law.
- 35.18 Yet, even if the courts had made a mistake, this would not make the conviction of Mr. Cornegruta an instance of indirect expropriation. In that regard, the Claimants' reliance on the *Biloune* case²⁵¹ is misplaced because the *Biloune* case is easily distinguishable on the facts. In *Biloune*, the claimant was expelled from the host State. The tribunal stressed that the claimant had a "central role" in "promoting, financing and managing" the investment vehicle and that his expulsion effectively prevented the investment vehicle from further pursuing its local development project.²⁵²
- 35.19 Presently, the Claimants have not even attempted to show how far Mr. Cornegruta had a central role and how his absence made it impossible to pursue KPM's investment activity. the Claimants only assert that Mr. Cornegruta was "a key member of the Claimants' management team"²⁵³ without specifying how his absence affected the "promoting, financing and managing" of the investment. At other instances, the Claimants are indeed less forceful and assert that Mr.

²⁴⁹ See Sections 18 to 30 and paragraphs 13.34, 13.42 and 14.7 to 14.35.

²⁵⁰ Section 27

²⁵¹ SoC, paragraph 283.

²⁵² *Biloune and Marine Drive Complex Ltd v. Ghana Investments Centre and the Government of Ghana*, Award, 27 October 1989, paragraph 209 (**Exhibit C-235**).

Cornegruta was merely an employee.²⁵⁴ Either way, this is in stark contrast to the *Biloune* case in which the person that could no longer take part in the management of the investment, Mr. Biloune, was the **investor** himself.

35.20 The Claimants' other allegations also fail because of the Republic's right to regulate. The request for tax audits, the assessment of back taxes, the alleged revocation of the purported approval of the transfer of shareholdings in TNG to Terra Raf and the seizure of assets to enforce the verdict against KPM were perfectly legal under Kazakh law and the appropriate reaction to the Claimants' breaches of the law. It would be absurd to require the Republic to compensate the Claimants simply because the Republic wanted to rectify the illegal situation created by the Claimants. Likewise, the Republic was under no obligation to prolong the Claimants' exploration rights under Contract No. 302.

(ii) The Claimants have not shown a sufficient intensity of host State interference

35.21 In any event, with regard to all of the actions complained of, the Claimants have not submitted sufficient proof that the economic value of the investments has been destroyed, as was required by *Tecmed*. For example, the mere allegation by employees and managers of KPM and TNG that the companies had to spend time and resources on the authorities' audit requests does entail that the companies had become useless. In fact, it is very unlikely that companies of the size of KPM and TNG, alleged by the Claimants to be worth at times US\$2.864 billion²⁵⁵, should not be able to deal with governmental requests.

35.22 In order to dispose of their burden of proof, the Claimants have to substantiate how many employees were at the companies' disposal, what kind of daily business these employees had to deal with, how much work the Republic's specific requests caused, how the requests were dealt with and what kind of daily business transactions could not be pursued because time and resources were being tied up elsewhere. The Claimants have not even attempted to do so. On the facts pleaded by The Claimants, it is impossible to ascertain whether the Claimants were "*radically deprived of the economical use and enjoyment of [their] investments*" or whether "*the economic value of the use, enjoyment or disposition of the assets or rights affected by the administrative action or decision have been neutralized or destroyed*", as the *Tecmed* tribunal put it. However, as mentioned, this is very unlikely, given the size and quality of operations of KPM and TNG.

35.23 In summary, no indirect expropriation occurred, both because the Republic merely exercised its regulatory powers and because the Claimants have not shown that they were deprived of their investments to an extent that warrants a finding of indirect expropriation

²⁵³ SoC, paragraph 283.

²⁵⁴ SoC, paras. 108, 117, 377.

²⁵⁵ SoC para 465

36 Most constant protection and security

36.1 The Republic always granted the Claimants' investments the most constant protection and security. It thus always acted in accordance with the third sentence of Article 10(1) ECT, which reads

"Such Investments shall also enjoy the most constant protection and security [...]"

36.2 The facts pleaded by the Claimants do not relate to the guarantee of most constant protection and security.

36.3 The Claimants' argument with regard to most constant protection and security is fundamentally flawed. That is because the facts put forward by the Claimants to substantiate that argument for a breach of the guarantee do not correspond in any way to the legal contents of the guarantee. Whereas the Claimants complain of specific alleged acts of harassment, the guarantee of most constant protection and security is not concerned with specific acts of the host State. Rather, the guarantee obligates the host State to diligently implement reasonable mechanisms of protection.

36.4 Most astoundingly, in their explanations of the law, the Claimants themselves recognised that the guarantee of most constant protection and security is limited to a guarantee of reasonable mechanisms of protection. For example, the Claimants cited the finding in the *AAPL* case according to which

*"[t]he 'due diligence' [required] is nothing more nor less than the **reasonable measures of prevention** which a well-administered government could be expected to exercise under similar circumstances."*²⁵⁶

36.5 This finding was implicitly confirmed by the tribunal in *Noble Ventures* which rejected the Claimant's arguments in the case because it could not "identify any specific failure by the Republic to exercise due diligence in protecting the Claimant".²⁵⁷ Likewise, it was held in the case of *AMT v. Zaire* – again in a passage cited by the Claimants – that under the guarantee, the host State "shall take all *measures* necessary to ensure the full enjoyment of protection and security".²⁵⁸

36.6 Yet, when arguing that the Republic breached the guarantee, the Claimants did not even attempt to show that the Republic had not implemented reasonable mechanisms of protection. Instead of dealing with the legal framework in place in the Republic and alleging shortcomings thereof, The

²⁵⁶ Asian Agricultural Products. Ltd. (*AAPL*) v. Democratic Socialist Republic of Sri Lanka, Award, 27 June 1990, ICSID Case No. ARB/87/3, paragraph 77 (emphasis provided), cited at SoC, paragraph 320 (**Exhibit C-255**).

²⁵⁷ *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 166. (**Exhibit R-66**)

²⁵⁸ *American Manufacturing and Trading, Inc. v. Zaire*, ICSID Case No. ARB/93/1, Award, 21 February 1997, paragraph 6.05 (emphasis provided), cited at SoC, paragraph 321 (**Exhibit C-256**).

Claimants jumped right to the alleged harassment by authorities of the Republic.²⁵⁹ Thus, the facts put forward by the Claimants with regard to most constant protection and security are completely disconnected from the Claimants' own legal understanding of the guarantee. This alone is fatal to the Claimants' claim.

The Claimants overstate the scope and intensity of protection

- 36.7 If one looks past the Claimants' completely disconnected pleading of the facts and only takes into account the Claimants' legal assessment of the guarantee of most constant protection and security, it must still be said that the Claimants' overstate the scope and intensity of protection under the guarantee. The Claimants try to establish that under the guarantee, host States have to provide for an investor's "legal security".²⁶⁰ This attempt must fail for several reasons:
- 36.8 For one, the guarantee of most constant protection and security in the ECT is simply mirroring the minimum standard of treatment under customary international law.²⁶¹ The tribunal in the *AAPL* case was clear in pointing out that terms such as "most constant protection and security" or "full protection and security" have been used in bilateral treaties since the 19th century.²⁶² When using these terms, States hence deliberately refer to the minimum standard of treatment that emerged back then.²⁶³ This has been affirmatively stated by the *AMT v. Zaire* tribunal which held that under the BIT in question, the "*treatments of protection and security [...] must not be any less than those required by international law.*"²⁶⁴
- 36.9 In light of this inherent limitation of the guarantee of most constant protection and security, arbitral tribunals and international courts have made it clear that "violations of protection standards are not easily to be established".²⁶⁵ Moreover, it has been affirmatively held by numerous arbitral tribunals that "protection and security" only refers to situations where the **physical security** of the investor or its investment is at issue.²⁶⁶ "Legal security" can hence not form part of the guarantee.

²⁵⁹ SoC, paras. 329 et seqq.

²⁶⁰ SoC, paras. 325 et seqq.

²⁶¹ UNCTAD, *Bilateral Investment Treaties in the Mid-1990s*, cited in Bishop et al., *Foreign Investment Disputes*, p.1062. (**Exhibit R-79**)

²⁶² *Asian Agricultural Products, Ltd. (AAPL) v. Democratic Socialist Republic of Sri Lanka*, Award, 27 June 1990, ICSID Case No. ARB/87/3, paragraph 47 (**Exhibit C-255**).

²⁶³ Cf. also Sornarajah, *The International Law on Foreign Investment*, p.237. (**Exhibit R-80**)

²⁶⁴ *American Manufacturing and Trading, Inc. v. Zaire*, ICSID Case No. ARB/93/1, Award, 21 February 1997, paragraph 6.06 (**Exhibit C-256**). In that regard, the Noble Ventures tribunal also noted that "it seems doubtful whether that provision can be understood as being wider in scope than the general duty to provide for protection and security of foreign nationals found in the customary international law of aliens.", *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 164. (**Exhibit R-66**)

²⁶⁵ *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 165, (**Exhibit R-66**) referring to the findings of the ICJ in *Elettronica Sicula S.p.A. (ELSI)*, Judgment (20 July 1989), I.C.J. Reports 1989, p.15.

²⁶⁶ *BG Group Plc v. Argentina*, Award, 24 December 2007, paragraph 326 (**Exhibit C-268**); *Saluka Investments BV (The Netherlands) v. The Czech Republic*, Partial Award, 17 March 2006, paragraph 484 (**Exhibit C-259**); *Rumeli Telekom A.S. and Telsim Mobil Telekomikasyon Hizmetleri A.S. v. Kazakhstan*, ICSID Case No. ARB/05/16, Award, 29 July 2008, paragraph 668 (**Exhibit C-236**).

- 36.10 This is further supported by the fact that an obligation to provide “legal security” would in fact run counter to the purpose of the ECT. An obligation to provide legal security would be both extensive and inherently vague. It would be nearly impossible for a host State to determine whether the legal framework it is providing creates enough “legal security” for future tribunals to rule in its favour. Such uncertainty and the ensuing potentially extensive scope of host State duties under the treaty would in fact be counter-productive for the purpose of furthering investment activity. As the *Saluka* tribunal stated, to assume an exaggerated treaty standard of protection as presently advocated by the Claimants would dissuade host States from admitting foreign investments and thus in fact undermine the purpose of the Treaty:

“[...] an interpretation which exaggerates the protection to be accorded to foreign investments may serve to dissuade host States from admitting foreign investments and so undermine the overall aim of extending and intensifying the parties’ mutual economic relations.”²⁶⁷

- 36.11 This holds true all the more because there are already other treaty standards which deal with foreign investors’ need for “legal security” and which are far more appropriate to address the issue. It has long been accepted that an investor’s legitimate expectations as well as its interest in a stable and predictable business environment can play a role with regard to the guarantee of fair and equitable treatment.²⁶⁸ Countless tribunals have ruled on fair and equitable treatment and have developed the guarantee to an extent that allows a sophisticated legal debate of the issue. This can certainly not be said with regard to the Claimants’ proposition of an obligation to provide “legal security” as part of the guarantee of most constant protection and security. Hence, the guarantee should not be extended in a way as to also provide for a duty of protecting “legal security”.

The Republic at all times granted most constant protection and security

- 36.12 The Republic acted at all times in compliance with the guarantee of most constant protection and security. As established above, the Claimants have completely failed to address the decisive question of whether the Republic provided sufficient mechanisms of protection. Since it is for the Claimants to prove the lack of sufficient mechanisms, their claim fails on this ground alone. In the following, the Republic will nonetheless address the issue of most constant protection and security to its full extent and will show that also when applying the relevant set of facts, there was no violation of the guarantee.
- 36.13 Under this approach, the Claimants’ claim fails first and foremost because there were no physical violations of the Claimants’ investment. The Claimants have never pleaded that any of its assets

²⁶⁷ *Saluka Investments BV (The Netherlands) v. The Czech Republic, Partial Award, 17 March 2006, paragraph 300 (Exhibit C-259)*. The tribunal in *Saluka* made this statement with regard to fair and equitable treatment. However, the idea applies to all treaty standards.

were physically harmed. Moreover, the Claimants cannot complain that the Republic took over KPM's and TNG's assets by use of force. Rather, the assets had been abandoned and have since been held in trust management by KazMunaiGas. Finally, nothing else follows from the conviction of Mr. Cornegruta. As established above, Mr. Cornegruta's sentence was legally rendered in a fair trial. It was appealable and upheld upon appeal. Under these circumstances, it cannot be argued that the Republic did not grant most constant protection and security.

- 36.14 What is more, even applying the exaggerated standard pleaded by the Claimants, under which a State is obliged to provide "legal security", the Claimants' case would have to fail. That is because the legal and administrative system of the Republic is fully equipped and well within the boundaries of what can be expected from a diligently governed State. There were thus sufficient mechanisms for protecting the Claimants' "legal security".
- 36.15 For the sake of completeness, the Republic would also like to point out that even a showing of a lack of sufficient protection mechanisms is not enough for the Claimants' claim to work. As the *Noble Ventures* tribunal pointed out, an investor must not only establish the insufficiency of the protection mechanisms but also establish that the alleged losses and injuries would have been prevented but for the alleged insufficiency.²⁶⁹ Again, no such facts were pleaded by the Claimants.

37 Fair and Equitable Treatment

- 37.1 The Republic submits that none of the Claimants' allegations warrant the finding of a breach of the fair and equitable treatment standard. To this effect, the Republic will set out its analysis in two steps: First, the Republic will show that the Claimants' claim fails because the Claimants did not try to rectify the actions of the Republic which it complains of in the appropriate forum. Secondly, the Republic will analyse each and every action the Claimants complain of and will show that even taking into account all of the Republic's actions, no breach of the standard occurred.

Failure to pursue available remedies

- 37.2 The Claimants have muddled together various unrelated actions of the Republic's authorities and now argue that these actions taken together amount to a breach of the guarantee of fair and equitable treatment. Yet, for the analysis of whether the standard of fair and equitable treatment has been breached, these actions cannot even be taken into account. That is because the Claimants complain exclusively about alleged breaches of contract or of domestic law. However, both breaches of contract and of domestic law should have been first brought before the

²⁶⁸ See *infra* paragraph 37.

²⁶⁹ *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 166 (**Exhibit R-66**).

competent forum, i.e. either before the contractually agreed upon arbitral tribunals or before the Republic's domestic courts.

- 37.3 The Claimants did not do so. They either failed to bring claims at all or they did not appeal court judgments where they could have done so. Instead, only five days after the Republic took into trust management the Claimants' assets, the Claimants initiated the present arbitral proceedings.
- 37.4 The Claimants' failure to pursue the available remedies excludes the possibility that the Republic's alleged breaches can now be taken into account for the analysis of fair and equitable treatment. As a result, the Claimants' claim must fail.
- 37.5 The Republic will make its submissions regarding the Claimants' failure in two steps: First, the Republic will address the issue from an international law perspective and will show that the failure to invoke the proper fora is fatal to the Claimants' claim. Second, the Republic will show how the actions of the Republic's authorities could have been addressed before the local courts or before the contractually agreed arbitral tribunals.

(a) A failure to pursue available remedies bars the investor from invoking a breach of fair and equitable treatment

- 37.6 Under an international investment treaty such as the ECT, a host State's actions cannot be scrutinized under the standard of fair and equitable treatment if the host State provided for domestic remedies or if the contract in question provided for a forum selection clause and if the investor then did not pursue these remedies.
- 37.7 To begin with, it is generally agreed that under the standard of fair and equitable treatment, a tribunal does not only have to look at the actions of the host State, but must also take into account the totality of the circumstances, including the conduct of the investor.²⁷⁰ Naturally, this also includes the host State's precautions against and the investor's reaction to alleged breaches of domestic law or contract.
- 37.8 In cases where there is an available remedy - either stemming from domestic statutory provisions or from a contractually agreed forum selection clause -, the investor obtains a right to resolve a dispute. In other words, the host State grants the investor a specific mechanism under which an alleged breach of domestic law or contract can be resolved.
- 37.9 Clearly, the granting of such mechanism, if it works properly, must be considered as an action of the host State which is favourable to the investor, aimed at ensuring a fair and equitable treatment. If an investor, when a dispute comes into existence, does not pursue such mechanism, this counter-acts the allegation that the host State acted unfairly and inequitably.

37.10 Taking this approach also allows another important fact to be taken into account: That the host State cannot guarantee that all of its officials, even at the lowest levels of administration, always act in accordance with the laws. Such guarantee would entail an extensive and potentially unworkable liability. Host States create particular systems to rectify low level breaches of the law and it is fair and equitable to expect investors to go through these systems before turning to international arbitration. The analysis of fair and equitable treatment may therefore not be limited to particular actions of the host State but must take into account the whole legal system provided by the host State for the benefit of the investor.

37.11 In view of these considerations, a general consensus has emerged that in scrutinizing fair and equitable treatment, decisive relevance should be given to the consideration whether the host State's legal system was tested by the investor and was sufficiently equipped to address incorrect decisions. For example, the annulment committee in *Helnan v. Egypt* stated that

*"Of course, a claimant's prospects of success in pursuing a treaty claim based on the decision of an inferior official or court, which had not been challenged through an available appeal process, should be lower, since the tribunal must in any event be satisfied that the failure is one which displays **insufficiency in the system**, justifying international intervention."*²⁷¹

37.12 Other tribunals went on to consider the practical implications of this approach and determined that in cases of a sufficient domestic system of redress - either stemming from domestic law or from a contractual forum selection clause - a failure to pursue the available remedies excludes the possibility of a breach of the fair and equitable treatment standard.

37.13 For a start, the claimant in *Parkerings v. Lithuania*²⁷² argued that there was a breach of the fair and equitable treatment standard because the host State "*did not act in good faith during the contractual relationship, refused to renegotiate the Agreement in good faith, and finally, decided unilaterally to terminate the Agreement*".²⁷³ Yet, the claimant had not pursued his claim in Lithuanian courts, the contractually agreed dispute resolution forum. The tribunal considered this omission as fatal to the claimant's argument on fair and equitable treatment and rejected the claim.²⁷⁴ In particular, it held:

"Under certain limited circumstances, a substantial breach of a contract could constitute a violation of a treaty. So far, case law has offered very few illustrations of such a situation. In most cases, a preliminary determination by a competent court as to whether the

²⁷⁰ Muchlinski, "Caveat Investor"? The Relevance of the Conduct of the Investor Under the Fair and Equitable Treatment Standard, 55 Int'l & Comp. L.Q., 527, 530 et seq. (2006) (**Exhibit R-87**).

²⁷¹ *Helnan International Hotels A/S v. Arab Republic of Egypt*, ICSID Case No. ARB/05/19, Decision on the Application for Annulment, 14 June 2010, paragraph 48. (**Exhibit R-88**)

²⁷² *Parkerings-Compagniet AS v. Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007 (**Exhibit R-1**).

²⁷³ *Ibid.*, paragraph 314.

²⁷⁴ *Ibid.*, paragraph 320.

*contract was breached under municipal law is necessary. This preliminary determination is even more necessary if the parties to the contract have agreed on a specific forum for all disputes arising out of the contract.*²⁷⁵

37.14 In the case of *MCI v. Ecuador*,²⁷⁶ the tribunal dealt *inter alia* with the revocation of an operating permit. The claimant's subsidiary in the case did not appeal the revocation even though it could have done so before an administrative review body.²⁷⁷ In the view of the tribunal, the claimant's subsidiary hence "acquiesced in cancellation of the permit".²⁷⁸ Specifically, the tribunal stressed that

*"Among the legitimate expectations that [the claimant's subsidiary] might invoke in arguing a violation of the fair and equitable treatment and good faith, the Tribunal cannot consider relevant the mere claim of ignorance of the legal effects of the revocation or of the existence of a remedy for challenging it."*²⁷⁹

37.15 As a result, the tribunal dismissed the claim for breach of the fair and equitable treatment standard in that regard.²⁸⁰

37.16 Likewise, the tribunal in the *Waste Management* case, when finding that there was no breach of Article 1105(1) NAFTA, assigned particular importance to the fact "that some remedy is open to the creditor to address the problem."²⁸¹

37.17 As a result, under international law, the Claimants cannot rely on any action of the Republic they could have brought to the attention of a contractually agreed forum or the Republic's domestic courts.

(b) The remedies available against the actions of the Republic were not pursued

37.18 Presently, all acts of the Republic could have been put under scrutiny before contractually agreed arbitral tribunals or before the Republic's domestic courts.

37.19 The Claimants suggest that the Republic breached the standard of fair and equitable treatment with regard to the following allegations:²⁸²

(a) The determination that KPM was operating trunk pipelines;

²⁷⁵ *Ibid.*, paragraph 316.

²⁷⁶ *M.C.I. Power Group L.C. and New Turbine, Inc. v. Ecuador*, ICSID Case No. ARB/03/6, Award, 31 July 2007. (**Exhibit R-103**)

²⁷⁷ *Ibid.*, paragraph 302.

²⁷⁸ *Ibid.*

²⁷⁹ *Ibid.*, paragraph 303.

²⁸⁰ *Ibid.*, paragraph 305.

²⁸¹ *Waste Management, Inc. v. United Mexican States (Number 2)*, ICSID Case No. ARB(AF)/00/3, Final Award, 30 April 2004, paragraph 115 (**Exhibit C-234**).

²⁸² SoC, paragraph 351, lit. a - f.

- (b) the trial and conviction of Mr. Cornegruta and the verdict against KPM;
- (c) the decision of the Republic's authorities not to prolong the exploration rights under Contract No. 302;
- (d) the imposing of corporate back taxes, export duties and rent taxes as well as the subsequent withdrawing of some tax charges;
- (e) the alleged revocation of the Republic's purported consent to the transfer of TNG to Terra Raf;
- (f) the series of inspections and audits in 2008 and 2010;
- (g) the seizure of KPM's assets based on the verdict against KPM;
- (h) the termination of KPM's and TNG's contracts, allegedly without giving enough time to respond and without keeping the contractually agreed notice period;
- (i) the taking into trust management of KPM's and TNG's assets after the termination of the contracts.

37.20 Of these actions, the ones listed under (c), (d), and (h) in fact arise from the Subsoil Use Contracts and Contract No. 302. As set out above, these contracts contain arbitration clauses.²⁸³ Thus, the Claimants should have brought their allegations set out above in (c), (d) and (h) to the respective arbitral tribunals. The fact that the Claimants did not do so bars them from invoking these allegations before the present arbitral tribunal.

37.21 With regard to the remaining allegations in (a), (b), (e), (f), (g) and (i), the Claimants can likewise not invoke the fair and equitable treatment standard. The Claimants could have pursued these claims before the domestic courts of the Republic but, in relation to the allegations at (e), (f), (g) and (i) they did not do so. Insofar as they did for allegations (a) and (b), the Claimants did not pursue the available remedies to their full extent. In particular none of these issues have gone to the Supreme Court (which can go so far as to hear a challenge to a government decree). Certainly the Claimants do not say they were denied the right of further appeal.

37.22 Hence, for their fair and equitable treatment claim, the Claimants cannot rely on any of the Republic's actions and their claim fails in its entirety.

The Republic continuously treated the Claimants fairly and equitably

²⁸³ Paragarph 33.18 to 33.21

37.23 The Claimants were treated by the Republic at all times fairly and equitably. Even if the Claimants could bring the acts they complain of to the attention of this tribunal, there is no doubt that the Republic accorded the Claimants' investments the proper treatment owed under the ECT.

(a) Scope and intensity of protection under the fair and equitable treatment standard

37.24 As is apparent from its wording, the fair and equitable treatment standard is an inherently vague guarantee. The broad formulation of the standard grants host States broad discretion in its dealings with investors. This is in line with "the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders."²⁸⁴ Thus, only in cases of blatant misconduct can a finding of unfair and inequitable treatment occur.

37.25 Tribunals have constantly set a high bar for a finding of a breach of the standard. For example, the tribunal in the *Genin* case stated that a finding of a breach of the standard requires

*"wilful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith."*²⁸⁵

37.26 Likewise, the *S.D. Myers* tribunal held that a breach of the standard presupposes

*"that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective."*²⁸⁶

37.27 A more detailed, but equally restrictive definition was developed by the tribunal in *Waste Management*:

*"[F]air and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety—as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process."*²⁸⁷

37.28 Further, the purpose of investment treaties in general and of the ECT in particular warrants that the fair and equitable treatment standard is understood restrictively. In that regard, the quotation from *Saluka* already cited above must be reiterated. Referring to the purpose of the BIT in

²⁸⁴ *S.D. Myers, Inc. v. Canada*, First Partial Award, 13 November 2000, paragraph 263 (**Exhibit C-287**).

²⁸⁵ *Genin and others v. Estonia*, ICSID Case No. ARB/99/2, Award, 25 June 2001, paragraph 367. (**Exhibit R-107**)

²⁸⁶ *S.D. Myers, Inc. v. Canada*, First Partial Award, 13 November 2000, paragraph 263 (**Exhibit C-287**).

²⁸⁷ *Waste Management, Inc. v. United Mexican States (Number 2)*, ICSID Case No. ARB(AF)/00/3, Final Award, 30 April 2004, paragraph 98 (**Exhibit C-234**).

question, the tribunal in *Saluka* graphically warned of the consequences of a too investor-friendly approach:

*“[A]n interpretation which exaggerates the protection to be accorded to foreign investments may serve to dissuade host States from admitting foreign investments and so undermine the overall aim of extending and intensifying the parties’ mutual economic relations.”*²⁸⁸

(b) Role of domestic law

37.29 Investment tribunals have frequently stated that mere breaches of the host State’s domestic law are not sufficient to find a breach of fair and equitable treatment. Rather, “something more” than simple illegality is required.²⁸⁹

37.30 However, investment tribunals have already been very reluctant to even find breaches of domestic law. In particular, tribunals frequently apply a high level of deference to determinations by domestic courts.²⁹⁰ For example, the tribunal in *Waste Management* accepted the local courts’ judgments arguing that

*“The Mexican court decisions were not, either ex facie or on closer examination, evidently arbitrary, unjust or idiosyncratic. There is no trace of discrimination [...] and no evident failure of due process.”*²⁹¹

37.31 The *Mondev* tribunal put it in equally clear terms:

*“In the end the question is whether, at an international level and having regard to generally accepted standards of the administration of justice, a tribunal can conclude in the light of all the available facts that the impugned decision was clearly improper and discreditable, with the result that the investment has been subjected to unfair and inequitable treatment.”*²⁹²

(c) Typical elements of fair and equitable treatment

37.32 In recent years, typical facts have crystallized in which tribunals usually find a breach of the fair and equitable treatment standard. The Claimants have listed these facts in their SoC.²⁹³ In

²⁸⁸ *Saluka Investments BV (The Netherlands) v. The Czech Republic*, Partial Award, 17 March 2006., paragraph 300 (**Exhibit C-259**).

²⁸⁹ Cf. *ADF Group Inc. v. United States*, ICSID Case No. ARB (AF)/00/1, Award, 9 January 2003, paragraph 190, (**Exhibit R-155**) with reference to *Elettronica Sicula S.p.A. (ELSI)*, Judgment (20 July 1989), I.C.J. Reports 1989, p.15, paragraph 124.

²⁹⁰ Cf. *Azinian, Davitian, & Baca v. Mexico*, ICSID Case No. ARB (AF)/97/2, Award, 1 November 1999, paragraph 99. (**Exhibit R-89**)

²⁹¹ *Waste Management, Inc. v. United Mexican States (Number 2)*, ICSID Case No. ARB(AF)/00/3, Final Award, 30 April 2004, paragraph 130 (**Exhibit C-234**).

²⁹² *Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, Award, 11 October 2002, paragraph 127 (**Exhibit C-274**).

²⁹³ SoC, paragraph 345.

particular, the Claimants refer to the protection against actions in bad faith, the protection of legitimate expectations, the reliance on a stable and predictable business environment, the expectation of due process and the protection against interference with contractual relationships, harassment or coercive conduct.²⁹⁴

37.33 The Republic agrees that these facts are typical cases for invoking the standard of fair and equitable treatment. However, the existence of these facts does not mean that tribunals no longer have to weigh all the circumstances of the case. The standard of fair and equitable treatment still only grants a vague guarantee under which all facts and circumstances must be taken into account,²⁹⁵ including elements such as the ones invoked by the Claimants. Legitimate expectations, the business environment, the good faith of the host State's conduct and other elements thus are not in and of themselves decisive for a breach of fair and equitable treatment but they do play a role in weighing all the circumstances of the case.

37.34 In the following, the Republic will address the Claimants' various allegations with regard to fair and equitable treatment and will show that in each and every case, the Republic treated the Claimants fairly and equitably.

(d) The determination that KPM was operating trunk pipelines

37.35 With regard to the issue of pipeline classification, the Claimants make several allegations, none of which survive closer scrutiny:

37.36 For a start, the Claimants argue that the Republic applied the reclassification in an *"inconsistent"* manner. Relying on the *MTD* case, the Claimants conclude that this as such constitutes a breach of the fair and equitable treatment standard.²⁹⁶ Yet, the Claimants' argument fails both on law and facts. On the facts, the Claimants' allegation that *"the Judicial Executor tasked with enforcing the court's order against KPM admitted that the segment was merely a 'field' pipeline"* is completely incorrect. The judicial executor (Chief of the Aktau Territorial Department) was stating only it was constructed as a field pipeline. The method of the pipelines' construction does not alter its characterisation, which is a matter of Kazakh law. The judicial executor was therefore not reclassifying the pipeline but merely referred to it in a confusing way.

37.37 Moreover, on the law, the Claimants' argument is patently absurd. Even if it were true that the "Judicial Executor" had made such an admission, this would not constitute unfair or inequitable treatment. The "Judicial Executor", under the Republic's domestic law, has the competence to enforce court orders, not the competence to rule on the status of pipelines. The Claimants cannot

²⁹⁴ SoC, paragraph 345.

²⁹⁵ Cf. *Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, Final Award, 11 October 2002, paragraph 118 (**Exhibit C-274**).

²⁹⁶ SoC, paragraph 351, lit. a, 2nd bullet point.

simply not rely on statements of incompetent authorities, in particular when the competent officials, i.e. the Financial Police and the courts, clearly found the opposite.

- 37.38 As to the Claimants' allegation that the Republic overstated the Claimants' illegal profits from the incorrectly classified pipelines,²⁹⁷ the Republic refers to its factual statements made above. The calculation of the illegal profits was perfectly correct and in accordance with the law. In any event, even if the calculation was incorrect, as stated above, "*something more*" than simple incorrectness under domestic law is required.
- 37.39 The Republic further denies any claims of discrimination with regard to the pipeline classification²⁹⁸ and will address this issue separately below.²⁹⁹
- 37.40 Moreover, the Claimants allege that they expected their licences for field pipelines to be sufficient for the pipelines they were operating. According to the Claimants, the later finding of the courts and the authorities that the Claimants should have obtained licences for the operation of trunk pipelines frustrated their earlier legitimate expectations.³⁰⁰ This finding cannot stand for the simple reason that the licence only informed them what type of pipeline they 'could' operate not what they actually did operate. It would therefore be completely unreasonable for the Claimants to have an expectation that they could operate a pipeline which went beyond what it was actually licenced to operate. As a matter of fact, all of the previous licences were simply not sufficient for the type of pipeline the Claimants was operating.
- 37.41 The Claimants also complain that their legitimate expectation of proper and fair governmental conduct was not fulfilled.³⁰¹ This is clearly not true since the Republic treated the Claimants at all times even-handedly. Moreover, the concept of legitimate expectations, as understood by arbitral tribunals in the past, addresses specific assurances and not broad and general understandings any investor may have.³⁰²

(e) The trial and conviction of Mr. Cornegruta and the verdict against KPM

- 37.42 With regard to the court proceedings against Mr. Cornegruta and KPM, the Claimants suggest that there were violations of due process and that the Republic's conduct constituted a denial of justice.³⁰³
- 37.43 Tribunals have argued that a denial of justice may occur in cases of refusal of access to the courts, undue delay in court proceedings, serious inadequacies in the administration of justice

²⁹⁷ SoC, paragraph 351, lit. a, 3rd bullet point.

²⁹⁸ SoC, paragraph 351, lit. a, 4th bullet point.

²⁹⁹ Cf. *infra* paragraph 38.

³⁰⁰ SoC, paragraph 351, lit. a, 5th bullet point.

³⁰¹ *Ibid.*

³⁰² Cf. *Walter Bau v. Thailand*, Award, 1 July 2009, paragraph 11.11 (**Exhibit R-159**): "The legitimate expectations doctrine has been applied to protect the substantive expectations of investors where particular promises have been made [...]" (emphasis provided).

and clearly improper and discreditable court decisions.³⁰⁴ The standard for a finding of denial of justice is very high. As the tribunal in *Chevron* put it:

*“The test for establishing a denial of justice sets, as the Respondent has argued, a high threshold. While the standard is objective and does not require an overt showing of bad faith, it nevertheless requires the demonstration of “a particularly serious shortcoming” and egregious conduct that “shocks, or at least surprises, a sense of judicial propriety.”*³⁰⁵

37.44 The element of egregiousness has also been highlighted by *Jan Paulsson* in his treatise on denial of justice:

*“The modern consensus is clear to the effect that the factual circumstances must be egregious if State responsibility is to arise on the grounds of denial of justice.”*³⁰⁶

37.45 Contrary to what the Claimants seem to argue,³⁰⁷ for a finding of denial of justice, it is not enough to point to an alleged breach of domestic law. If a court does not act in accordance with domestic procedural law or comes to a decision that is not in accordance with domestic substantive law, this is far from sufficient for a finding of denial of justice. As was explained in *Pantechniki v. Albania*:

*“The general rule is that ‘mere error in interpretation of the national law does not per se involve responsibility.’ Wrongful application of the law may nonetheless provide ‘elements of proof of a denial of justice.’ **But that requires an extreme test: the error must be of a kind which no ‘competent judge could reasonably have made.’** Such a finding would mean that the State had not provided even a minimally adequate justice system.”*³⁰⁸

37.46 For the sake of completeness, it must be pointed out that as with standard of fair and equitable treatment in general,³⁰⁹ allegations of denial of justice are doomed to fail in any event if available local remedies are not pursued.³¹⁰

³⁰³ SoC, paragraph 351, lit. b.

³⁰⁴ Cf. *Azinian, Davitian, & Baca v. Mexico*, ICSID Case No. ARB (AF)/97/2, Award, 1 November 1999, paras. 102 et seq. (**Exhibit R-89**)

³⁰⁵ *Chevron Corporation (USA) and Texaco Petroleum Company (USA) v. The Republic of Ecuador*, PCA Case No. 34877, Partial Award on the Merits, 30 March 2010, paragraph 244 (emphasis provided) (**Exhibit C-285**). Cf. also *Loewen Group, Inc. and Raymond L. Loewen v. United States*, ICSID Case No. ARB(AF)/98/3, Award on Merits, 26 June 2003, paragraph 132 (**Exhibit C-275**).

³⁰⁶ Jan Paulsson, *Denial of Justice in International Law*, Cambridge University Press, 4th edition, 2007, p.60. (**Exhibit R-71**)

³⁰⁷ SoC, paragraph 351, lit. b, 3rd bullet point.

³⁰⁸ *Pantechniki S.A. Contractors & Engineers v. Republic of Albania*, ICSID Case No. ARB/07/21, Award, 30 July 2009, paragraph 94 (emphasis provided) (**Exhibit R-90**) (citing Gerald Fitzmaurice, “The Meaning of the Term ‘Denial of Justice,’” 1932 BYIL 93 at 111, n.1 and Charles de Vischer, “Le déni de justice en droit international”, (1935) 34 Recueil des cours 370 at 376).

³⁰⁹ See Section 37.1 to 37.22

³¹⁰ *Jan de Nul N.V. and Dredging International N.V. v. Arab Republic of Egypt*, ICSID Case No. ARB/04/13, Award, 6 November 2008, paragraph 258 et seq. (**Exhibit R-179**);

- 37.47 Presently, the Republic never denied justice to the Claimants. As explained above, the proceedings as well as the later decisions were both in accordance with domestic law and in accordance with international standards:
- 37.48 For a start, the Republic's courts administered and rendered justice in the trial against Mr. Cornegruta in a proper way. Mr. Cornegruta was heard, was represented at the trial and could present his legal position fully. Moreover, the sentence rendered against Mr. Cornegruta was correct under Kazakh law since he was an "entrepreneur" and KPM's pipelines were trunk pipelines. Even if there had been a mistake in applying Kazakh law, this would not amount to a mistake so egregious that it would allow the finding of a denial of justice. The matter turns on technical points and a mistake would clearly not meet the "extreme test" of denial of justice.
- 37.49 Moreover, the verdict against KPM was perfectly proper under Kazakh law. The imposing of a fine on KPM was correct, given the illegal conduct of KPM. What is more, KPM was never violated in its right to be heard. KPM was represented throughout the whole process by Mr. Cornegruta and as explained in Section 27 above, the proceedings were actually against KPM with Mr. Cornegruta representing KPM throughout the trial. The fact that KPM was not named a party to the proceeding was simply due to the fact that as an LLP, KPM could not be a named party in the criminal proceedings but instead a proceedings had to be commenced against the representative of KPM.
- 37.50 Finally, it is not true that the Financial Police interfered in any way improperly in the judicial proceedings.³¹¹ The Financial Police played its standard and legitimate role in the investigation and the proceedings.³¹²

(f) The Republic's decision not to prolong the exploration rights under Contract No. 302

- 37.51 The Claimants further assert that by not prolonging the exploration rights under Contract No. 302, the Republic did not act in accordance with the Claimants' legitimate expectations and did not provide a sufficiently stable and predictable business environment.³¹³ This argument is absurd on its face. According to the Claimants, intransparency and unpredictability were caused by the Republic not signing the necessary approval of the prolongation. Yet, what is unclear about an unsigned approval? An approval not signed is an approval not given. The lack of approval made it perfectly transparent that there simply was no prolongation of the exploration rights. The Claimants could plan its future business decisions accordingly.

Loewen Group, Inc. and Raymond L. Loewen v. United States, ICSID Case No. ARB(AF)/98/3, Award on Merits, 26 June 2003, paragraph 154, 156 (**Exhibit C-275**).

³¹¹ Cf. SoC, paragraph 351, lit. b, 2nd bullet point.

³¹² See Sections 26 and 27.

³¹³ Cf. SoC, paragraph 351, lit. c.

37.52 Nothing else follows from the alleged declaration made during contract negotiations that the Republic would prolong the exploration rights. The Claimants could not have reasonably expected that their exploration rights would be prolonged before the Republic had signed the addendum. Only through the signing of the addendum would there have been a prolongation. Before such signing, no party can reasonably expect that the other will act in accordance with the draft addendum. Otherwise, host States could not engage in prolongation negotiations without the fear of automatically prolonging the contract.

(g) The Republic's tax assessments

37.53 With regard to the Republic's tax assessments, the Claimants are raising several complaints: that the Republic assessed USD 6 million in back transfer price taxes and penalties against KPM and TNG, that KPM was prohibited from exporting crude oil without paying the crude oil export tax, that the Financial Police interfered and made the Aktau territorial customs body render conflicting tax assessments and that the Republic in general acted inconsistently by changing its position on the various applicable taxes.³¹⁴

37.54 The Claimants' complaints fail in their entirety. For one, the Republic's back tax assessments were at all times in accordance with the law and thus also with the Claimants' contracts.³¹⁵ The authorities' compliance with domestic law has been reaffirmed by the Republic's courts on several occasions. Since the Claimants could not legitimately expect anything else but lawful tax assessments, there legitimate expectations were always fulfilled.

37.55 Specifically, the Claimants could not expect that there would not be any back tax assessments. KPM and TNG themselves had incorrectly declared taxes and in particular incorrectly deduced certain amounts with regard to the corporate tax and the transfer price tax. Naturally, the Claimants could not expect that their own incorrect tax declarations would not be corrected. This view is also supported by the opinion voiced in *Thunderbird v. Mexico* (**Exhibit C-266**). In this case, the investor tried to rely on declarations by Mexico's authorities with regard to the approval of gaming machines. The tribunal rejected any notion of such reliance because Mexico's declarations were caused by the investor incorrectly describing their gaming machines to the authorities.³¹⁶

(h) The transfer of TNG to Terra Raf

37.56 The Claimants further argue that the Republic approved the transfer of TNG to Terra Raf and waived its pre-emptive rights with regard to this transfer.³¹⁷ According to the Claimants, this

³¹⁴ Cf. SoC, paragraph 351, lit. d, 2nd, 4th, 5th and 6th bullet point.

³¹⁵ See Section 30.

³¹⁶ *International Thunderbird Gaming Corporation v. Mexico*, Arbitral Award, 26 January 2006, paras. 148 et seqq (**Exhibit C-266**).

³¹⁷ SoC, paragraph 351, lit. d, 3rd bullet point.

caused a legitimate expectation that the Republic would not later disapprove of the transfer and invoke its pre-emptive rights. However, as set out above,³¹⁸ the Claimants have not proven that they legitimately obtained an approval by the competent authorities of the Republic.³¹⁹ Their argument fails on this point of fact alone.

37.57 What is more, even if there had been an approval, it would be of no value for the Claimants' suggestion of legitimate expectations. Again, the principle set out in *Thunderbird v. Mexico* applies.³²⁰ The Claimants' application for the approval had inaccuracies and other issues.³²¹ Thus, any alleged approval of the transfer is flawed and cannot be the basis for legitimate expectations. It is also for this reason that any comparison to the *CME* case³²² must fail.

(i) The Republic's investigations, litigations and negotiations

37.58 The Claimants further allege that "months of litigation and negotiation" created an unstable and unpredictable business environment and that criminal investigations and inspections hindered KPM and TNG to operate normally.³²³ This argument cannot stand for the simple reason that all of the Republic's investigations and all of the proceedings brought were perfectly lawful. In addition, these investigations and proceedings were due to the Claimants' own illegal behaviour and can therefore not be the basis for a claim of unfair and inequitable treatment. In any event, it is part of the business environment in any State that investigations may be initiated or proceedings may be brought. The Claimants cannot expect that they would never have to deal with such situations.

(j) The termination of the contracts and the seizure of KPM and TNG's assets in June 2010

37.59 The Claimants also complain of the Republic's termination of its contracts with KPM and TNG and of the subsequent seizure of KPM's and TNG's assets.

37.60 For one, the Claimants allege that the terminations were not supported by the contractual termination ground.³²⁴ This is clearly not the case, as set out above.³²⁵

37.61 Moreover, the Claimants purport that the terminations were not in accordance with principles of due process since the Claimants did not have an opportunity to dispute or correct the Republic's arguments.³²⁶ Again, these allegations must fail.

³¹⁸ See Section 13.34 to 13.47

³¹⁹ *Ibid.*

³²⁰ *International Thunderbird Gaming Corporation v. Mexico, Arbitral Award, 26 January 2006, paras. 148 et seqq (Exhibit C-266).*

³²¹ See Section 13.34 to 13.47

³²² SoC, paragraph 351, lit. d, 4th bullet point.

³²³ SoC, paragraph 351, lit. e.

³²⁴ SoC, paragraph 351, lit. f, 1st bullet point.

³²⁵ See paragraph 31.20.

- 37.62 To begin with, any alleged procedural shortcoming in the termination is irrelevant: Even if due process had not been granted when the contracts were terminated, this would not change the fact that the Republic could validly terminate the contracts and that the Claimants thus stood to lose their contractual rights. If there had been any due process breach, it would not be this breach that would cause the Claimants' subsequent losses. Instead, it was the Republic's substantive right to terminate the contract that caused the Claimants' losses. This substantive right, however, was perfectly valid and in fact only the result of the Claimants' own misbehaviour.
- 37.63 In addition, the Claimants were perfectly able to dispute the Republic's grounds of termination because they could have initiated arbitration under the contracts at all times and could have had independent tribunals decide upon the reasons for the termination.³²⁷ The Claimants have not even attempted to show how a process before such tribunals would not have been in accordance with due process. Against this background, no due process violation can be found.
- 37.64 Lastly, the seizure of KPM's and TNG's assets was again no breach of fair and equitable treatment.³²⁸ As set out above,³²⁹ the seizure was legal under Kazakh law and it was necessary to continue gas production for the region. It was thus neither done in bad faith nor could it not have been expected.³³⁰

(k) Allegations of harassment and bad faith

- 37.65 Finally, the Claimants repeatedly allege that the Republic's actions were part of a harassment campaign and were implemented in bad faith.³³¹ For the reasons stated above,³³² this is not true and the Claimants have not submitted evidence which would even remotely support this allegation.

38 No Impairment Through Unreasonable or Discriminatory Measures

- 38.1 Article 10(1) ECT further protects investors from State conduct that is unreasonable or discriminatory:

"[...] Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal."

- 38.2 Presently, the Republic has acted in accordance with this guarantee. The Republic has always treated the Claimants in a reasonable and in a non-discriminatory way. Even if there had been

³²⁶ SoC, paragraph 351, lit. f, 2nd bullet point.

³²⁷ See Paragraphs 33.6 to 33.16.

³²⁸ SoC, paragraph 351, lit. f, 4th bullet point.

³²⁹ See paragraphs 31.153 to 31.155.

³³⁰ See paragraph 31.58.

³³¹ SoC, paragraph 351, lit. c, 4th bullet point, lit. d, 8th bullet point, lit. f, 5th bullet point.

instances of unreasonable or discriminatory conduct, these did not impair the “*management, maintenance, use, enjoyment or disposal*” of the Claimants’ investment.³³³

Unreasonable measures

- 38.3 The Republic’s actions were reasonable in each and every instance.
- 38.4 Protection against “unreasonable” measures is one of the standard guarantees of international investment law, provided for in practically every investment treaty. The precise wording of the guarantee varies, in that some treaties refer to measures that are “unjustified” or “arbitrary”. There is, however, no relevant distinction between the terms “unreasonable”, “unjustified” and “arbitrary” so these differences in wording have no bearing on the scope of the guarantee.³³⁴
- 38.5 It is clear from investment tribunal practice that a finding of a breach of the guarantee requires a high threshold. The classic interpretation of the guarantee was given by the ICJ in the *ELSI* case. With regard to the US/Italy FCN which used the term “arbitrary”, the court held that
- “Arbitrariness is not so much something opposed to a rule of law, but something opposed to the rule of law. [...] It is a wilful disregard of due process of law, **an act which shocks, or at least surprises, a sense of judicial propriety.**”³³⁵*
- 38.6 Further, the court clarified that mere breaches of domestic law or contract as such cannot lead to a breach of the guarantee.
- “[B]y itself, and without more, unlawfulness cannot be said to amount to arbitrariness. [...] To identify arbitrariness with mere unlawfulness would be to deprive it of any useful meaning in its own right.”³³⁶*
- 38.7 Investment tribunals have frequently relied on the high threshold established in *ELSI*.³³⁷ In that regard, the ICJ’s definition has even been called “the most authoritative interpretation of international law”.³³⁸
- 38.8 A further example for the high threshold required for the finding of a breach of the guarantee is the *CME* case, invoked by the Claimants.³³⁹ In this case, the tribunal based its finding of

³³² See Section 18.

³³³ Claimants only submitted arguments regarding impairment by unreasonable or discriminatory measures. However, at SoC, paragraph 354, fn. 560, Claimants suggest that the Republic also violated the national and the most-favoured nation treatment provision in Article 10(7) ECT without developing the argument further. For the avoidance of doubt: The Republic categorically rejects that it breached Article 10(7) ECT.

³³⁴ Cf. Schreuer, Protection against Arbitrary or Discriminatory Measures (**Exhibit R-180**).

³³⁵ *Electronica Sicula S.p.A. (ELSI)*, Judgment (20 July 1989), I.C.J. Reports 1989, p.15, paragraph 128 (emphasis provided) (**Exhibit R-81**).

³³⁶ *Electronica Sicula S.p.A. (ELSI)*, Judgment (20 July 1989), I.C.J. Reports 1989, p.15, paragraph 124 (**Exhibit R-81**).

³³⁷ Cf. e.g. *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 176 (**Exhibit R-66**);

LG&E v. Argentina, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, paragraph 157. (**Exhibit R-63**)

³³⁸ *Siemens A.G. v. Argentine Republic*, ICSID Case No. ARB/02/8, Award, 6 February 2007, paragraph 318 (**Exhibit C-232**).

“unreasonable” measures on the host State’s intention to deprive the investor of its investment.³⁴⁰ Thus, in this case, it was the host State’s outright bad faith that caused the tribunal to determine that there had been “unreasonable” measures.

- 38.9 Against this background, none of the Republic’s actions can be deemed “unreasonable”:
- 38.10 The Claimants first complain that the classification of their pipelines as “trunk pipelines”, the ensuing trial of Mr. Cornegruta, the verdict and fine against KPM and the following “freezing” of KPM’s assets were unreasonable.³⁴¹ Yet, this claim fails for the simple reason that all of these measures were taken out in accordance with the Republic’s laws and with the aim of rectifying the Claimants’ own breaches and transgressions of the law. The Claimants had operated trunk pipelines without a licence, a fact which was confirmed by the Republic’s independent courts. This fact warranted criminal proceedings and the imposing of a fine. The fine was not unreasonable but based on the court’s proper assessment of the due amount. Moreover, the Republic only took enforcement measures and “froze” KPM’s assets upon non-payment of the fine, which is a perfectly reasonable course of action.
- 38.11 In any event, even if there had been some mistakes in the application of the law, which the Republic categorically denies, this would not mean that the Republic had acted unreasonably. If there had been some incorrect assessment of the technical matters regarding the pipelines, this would clearly not shock or surprise a sense of judicial propriety.
- 38.12 Further, contrary to what the Claimants suggest,³⁴² the Republic’s actions with regard to the transfer of TNG to Terra Raf were also reasonable. The Republic was completely free in its decision of whether to approve this transfer. Not being legally bound in any way, both an approval and a disapproval would have been reasonable. Moreover, the Claimants cannot argue that the Republic unreasonably revoked its approval, simply because the Claimants have not shown that the Republic had ever approved of the transfer. In any event, even if there had been an approval, a revocation thereof would have been reasonable, given that the Claimants had wrongly informed the Republic of the details of the transfer.
- 38.13 Likewise, the Republic also acted completely reasonably in not prolonging the exploration rights under Contract No. 302.³⁴³ The Republic was again completely free in this decision. The fact that it did not prolong the exploration rights thus cannot be deemed unreasonable. Moreover, the Claimants could not reasonably rely on the fact that the exploration would be prolonged so long as the Republic had not signed the necessary addendum.³⁴⁴

³³⁹ SoC, paragraph 357.

³⁴⁰ CME Czech Republic B.V. v. Czech Republic, Partial Award, 13 September 2001, paragraph 612 (**Exhibit C-229**).

³⁴¹ SoC, paragraph 362, 1st bullet point.

³⁴² SoC, paragraph 362, 3rd bullet point.

³⁴³ Cf. SoC, paragraph 362, 4th bullet point.

³⁴⁴ See generally Section 13.

- 38.14 The Claimants' allegations with regard to tax assessments³⁴⁵ likewise fail. As explained above,³⁴⁶ the Republic's assessment of back taxes was in compliance with domestic law. Given the incorrect invocation of tax deductions by the Claimants, the Republic's back tax assessment was entirely reasonable. Likewise, the Kazakh courts legitimately determined that KPM was liable to pay the export tax imposed on it in accordance with the law.
- 38.15 In any event, even if there had been incorrect tax assessments, this would as such not give rise to unreasonableness. The Claimants seem to argue that any time a State holds a position not in line with its contractual agreements, it acts unreasonably and thus breaches international law. This can clearly not have been the intention of the States party to the ECT.
- 38.16 In addition, no fault can be found with regard to the termination of the contracts.³⁴⁷ There were valid grounds for a lawful termination of these contracts and the Republic simply exercised its right to terminate.
- 38.17 Finally, it must be reiterated that the Republic did not have the intention of depriving Claimants of their investments and that there was no campaign of harassment.³⁴⁸ Thus, no unreasonableness follows from an intentional deprivation of the investment, as was the case in *CME*.

Discriminatory measures

- 38.18 The Republic never discriminated against the Claimants.

The Claimants somewhat unclearly describe the standard of discrimination as requiring "a differential treatment applied to people who are in similar situations" and argue that there has to be a "rational justification for any differential treatment of a foreign investor."³⁴⁹ Such unclear description is not necessary, given that the tribunal in *Saluka* developed a very simple definition:

*"State conduct is discriminatory, if (i) similar cases are (ii) treated differently (iii) and without reasonable justification."*³⁵⁰

- 38.19 Importantly, in line with the general "onus probandi" rule, the burden of proof for the similarity of the cases and the differential treatment lies with the Claimants. This is for example evidenced by *BG v. Argentina*, in which the tribunal rejected a claim for discrimination because it found that the similarity of cases had not been sufficiently established.³⁵¹ Moreover, the tribunal also rejected the discrimination claim because of a lack of proof regarding the differential treatment - with the

³⁴⁵ SoC, paragraph 362, 5th and 6th bullet point.

³⁴⁶ Section 30.

³⁴⁷ SoC, paragraph 362, 7th bullet point.

³⁴⁸ SoC, paragraph 357.

³⁴⁹ SoC, paragraph 359, quoting *Goetz v. Burundi (Exhibit C-227)* and *Saluka v. Czech Republic (Exhibit C-259)*.

³⁵⁰ *Saluka Investments BV (The Netherlands) v. The Czech Republic, Partial Award, 17 March 2006, paragraph 313 (Exhibit C-259)*

³⁵¹ *BG Group Plc v. Argentina, Award, 24 December 2007, paragraph 357 (Exhibit C-268)*.

words of the tribunal: “it is not apparent that Argentina’s measures were ‘not taken under similar circumstances against another national.’”³⁵²

- 38.20 The tribunal in *Nykomb v. Latvia* (**Exhibit C-281**), interpreting Article 10(1) ECT, came to the same conclusion. Only after the tribunal had deemed established that there were like circumstances and that there was differential treatment did it find that the burden of proof had shifted and that it was now for the Republic to show that there was a reasonable justification for the differential treatment.³⁵³
- 38.21 Presently, the Claimants base their claim of discrimination on the classification of KPM’s and TNG’s pipelines as “trunk pipelines” and the ensuing criminal proceedings. Yet, the Claimants have completely failed to prove that there were similar cases and that these were treated differently.
- 38.22 To begin with, the investigation into the pipelines issue was not discriminatory. In that regard, it is important to note that KPM’s and TNG’s pipelines were not “*reclassified*”, as the Claimants allege.³⁵⁴ Rather, the Financial Police discovered that the pipelines were “trunk pipelines” and upon investigation found out that KPM and TNG did not have the necessary licences. The treatment of KPM and TNG was thus no different to that of any other company where such infringement was found or would have been found. The Republic’s authorities simply did what they had to do under the Republic’s laws.
- 38.23 Importantly, the Claimants failed to provide evidence of any case in which the Republic’s authorities did not step in when they had reason to believe that there were trunk pipelines being operated without a licence. In particular, contrary to what the Claimants argue,³⁵⁵ the pipelines of neighbouring companies do not support the Claimants’ position. The Claimants have not put forward any evidence that the neighbouring pipelines are trunk pipelines. In fact, the Claimants undermine their own argument in this regard because the comparable factors they cite are not relevant to the question of whether a pipeline is a trunk pipeline.³⁵⁶
- 38.24 It should be added that also with regard to the conviction of Mr. Cornegruta and the fine against KPM, there was no discrimination. The Claimants have not shown any case in which the authorities did not initiate criminal proceedings as a reaction to the operation of “trunk pipelines” without a licence.

³⁵² BG Group Plc v. Argentina, Award, 24 December 2007, paragraph 359 (**Exhibit C-268**).

³⁵³ Nykomb Synergetics Technology Holding AB v. Latvia, SCC, Award, 16 December 2003, paragraph 4.3.2, lit. a (**Exhibit C-281**).

³⁵⁴ SoC, paragraph 362, 2nd bullet point.

³⁵⁵ SoC, paras. 87, 362, 2nd bullet point.

³⁵⁶ Paragraph 23.19(d).

Impairment

- 38.25 In any event, the Republic's measures did not impair the Claimants' management, maintenance, use, enjoyment or disposal of KPM and TNG.
- 38.26 Again, it is for the Claimants to prove that there was any actual impairment of their investment through the Republic's measures. However, the Claimants have not even made the most rudimentary attempts at doing so. In particular, the Claimants have not tried to discern the effects of the Republic's actions from the effects of the Claimants' own poor management of KPM and TNG. This alone is fatal to the Claimants' claim.
- 38.27 To begin with, the Claimants did not adequately explain how the classification of the pipelines as trunk pipeline", the trial and conviction of Mr. Cornegruta and the fine against KPM affected KPM's and TNG's management, maintenance, use, enjoyment or disposal. It stands to reason that companies the size of KPM and TNG must be able to deal with such investigations, in particular if these investigations are only the result of the companies' own wrongdoing. In any event, the Claimants must demonstrate how their daily management activities were affected, whether there was a cut in dividends and how and why the Claimants could no longer dispose of KPM and TNG. They have not done so.
- 38.28 Moreover, it remains completely unclear how KPM and TNG were affected by the dispute regarding the Republic's alleged approval of TNG's transfer to Terra Raf. The mere assertion that The Claimants were impaired in their ability to market KPM and TNG to potential buyers is not sufficient.³⁵⁷ the Claimants have to show specific sales prospects which ceased to exist due to the dispute.
- 38.29 Lastly, no impairment follows from the refusal to extend the exploration period under Contract No. 302, the back tax assessments and the imposition of export taxes.³⁵⁸ In all of these instances, KPM and TNG had no right and no advantage taken from them. From the very beginning, KPM and TNG could not expect that the exploration period under Contract No. 302 would be extended because the Republic was free to decide whether it wanted to prolong the contract. Likewise, the Claimants could not expect that no back taxes would be assessed and that the export tax would not be imposed. The Republic was entitled to the payment of these taxes.
- 38.30 All in all, the Claimants have thus not established that there were any adverse effects. They can hence not argue that the Republic impaired their management, maintenance, use, enjoyment or disposal of KPM and TNG through unreasonable or discriminatory measures.

³⁵⁷ SoC, paragraph 362, 3rd bullet point.

³⁵⁸ SoC, paragraph 362, 4th, 5th, 6th and 7th bullet point.

39 Observance of Obligations

39.1 The Claimants can further not base their claims on the Republic's duty to "observe any obligations it has entered into with an Investor or an Investment of an Investor" under the last sentence of Article 10(1) ECT. This "umbrella clause" does not create any liability for the Republic. Firstly, the umbrella clause does not extend to obligations arising out of a host State's domestic law. Secondly, the exclusive dispute resolution clauses in the Subsoil Use Contracts and Contract No. 302 bar the Claimants from bringing alleged violations of these contracts to this Tribunal. Thirdly and in any event, the Republic acted at all times in accordance with its domestic law and with the Subsoil Use Contracts.

The umbrella clause does not extend to obligations in the Republic's domestic law

39.2 Large parts of the Claimants' case with regard to the umbrella clause are based on alleged breaches of the Republic's domestic law. Yet, the umbrella clause does not allow the Claimants to rely on alleged violations of domestic law before this Tribunal. The wording of the umbrella clause clearly shows that the effect of the umbrella clause is limited to contractual obligations. Investment case law further bolsters this position.

39.3 As to the wording, it is important to note that according to its Article 50, the ECT has six authentic languages: English, French, German, Italian, Russian and Spanish. The texts in all five languages are clear in limiting the scope of the umbrella clause to obligations stemming from contracts. The French and Spanish versions even contain the respective verbs for the noun "contract":

*"Chaque partie contractante respecte les obligations qu'elle a **contractées** vis-à-vis d'un investisseur ou à l'égard des investissements d'un investisseur d'une autre partie contractante."*

*"Toda Parte Contratante cumplirá las obligaciones que haya **contraído** con los inversores o con las inversiones de los inversores de cualquier otra Parte Contratante."*

39.4 Likewise, the English, Italian and Russian versions of the text are clear in pointing out that the relevant obligations must be "entered into" or "assumed with regard to" the investor or investment. This also shows that only obligations stemming from a contract are relevant.

*"Each Contracting Party shall observe any obligations it has **entered into with an Investor** or an Investment of an Investor of any other Contracting Party"*

*"Ciascuna Parte contraente adempie eventuali obblighi **assunti riguardo ad un investitore** o un investimento effettuato da un investitore di una qualsiasi altra Parte contraente."*

*“Jede Vertragspartei erfüllt alle Verpflichtungen, die sie **gegenüber einem Investor oder einer Investition eines Investors** einer anderen Vertragspartei **eingegangen** ist.“*

“Каждая Договаривающаяся Сторона соблюдает все обязательства, которые она приняла в отношении Инвестора или Инвестиции Инвестора любой другой Договаривающейся Стороны.”

- 39.5 In this regard, the ECT is clearly in line with the practice of investment treaties in general. Umbrella clauses in other BITs generally do not extend to obligations contained in the host State’s domestic law.
- 39.6 Investment tribunals have been very reluctant to extend the scope of umbrella clauses to domestic law. The tribunal in *Al-Bahloul v. Tajikistan*, when dealing with the present umbrella clause under the ECT, was firm in holding that it “does not refer to general obligations of the State arising as a matter of law.”³⁵⁹
- 39.7 Moreover, in the handful of cases involving Argentina, in which other contractual obligations were found to fall under the scope of the umbrella clause, this was due to some very specific circumstances. Argentina had enacted specific legislation targeting investors and had advertised the guarantees contained in this legislation in “offering memorandums” which were addressed to the investors. It was only for this reason that the Tribunals in *LG&E* and *Enron* (a case surprisingly cited by the Claimants in their favour) came to the conclusion that the umbrella clause extended to the specific obligations contained in the advertised legislation.³⁶⁰ In the present case, there clearly was no such targeting of foreign investors by the Republic.
- 39.8 To be clear: There is no reported case in which the scope of the umbrella clause was extended to domestic law unconditionally. The wording of the ECT clearly speaks against any attempts to do so in the present case. The Claimants’ claims of violations of domestic law under the umbrella clause fail for this ground alone.

The Claimants also cannot bring claims for breach of contract under the umbrella clause

- 39.9 The Claimants’ reliance on the umbrella clause is equally misplaced with regard to the alleged breaches of the Subsoil Use Contracts and Contract No. 302. While breaches of contract can

³⁵⁹ *Mohammad Ammar Al-Bahloul v. Republic of Tajikistan*, SCC Case No. V (064/2008), Partial Award on Jurisdiction and Liability, 2 September 2009, paragraph 257. (**Exhibit R-181**)

Cf. also *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Annulment Decision, 25 September 2007, paragraph 95, lit. a. (**Exhibit R-182**)

³⁶⁰ *LG&E v. Argentina*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, paragraph 175 (**Exhibit R-63**); *Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3, Award, 22 May 2007, paras. 264, 275 (cited at SoC, paragraph 370) (**Exhibit C-263**).

Cf. also the case of *Continental Casualty Company v. Argentina*, ICSID Case No. ARB/03/9, Award, 5 September 2008, paras. 300 et seq. (**Exhibit R-183**), in which the tribunal rejected considering domestic law under the umbrella clause precisely because there was no specific targeting of investors.

generally fall under the scope of the umbrella clause,³⁶¹ The Claimants are barred from invoking these contracts because they contain exclusive arbitration clauses.³⁶² The Claimants never initiated arbitration under any of these arbitration clauses.

- 39.10 Investment tribunals have been firm in insisting that claims under an umbrella clause cannot be brought so long as the requirements of an exclusive forum selection clause have not been complied with. The rationale behind this is simple: By including forum selection clauses in their contracts, the investor and the host State agree to tie the material obligations of the contract to the resolution in a certain forum. To allow an investor to bring a contract claim by way of an investment treaty would thus breach the principle of *pacta sunt servanda*.³⁶³ As a consequence, as long as the process in the selected forum is not gone through, claims arising from the contract are simply not ripe for arbitration under an investment treaty. As the tribunal in *SGS v. Philippines* put it:

*“The question is whether a party should be allowed to rely on a contract as the basis of its claim when the contract itself refers that claim exclusively to another forum. In the Tribunal’s view the answer is that it should not be allowed to do so, unless there are good reasons, such as force majeure, preventing the claimant from complying with its contract. This impediment, based as it is on the principle that a party to a contract cannot claim on that contract without itself complying with it, is more naturally considered as a matter of admissibility than jurisdiction.”*³⁶⁴

- 39.11 This position was later adopted by the tribunal in *BIVAC v. Paraguay*³⁶⁵ and also found support among commentators.³⁶⁶
- 39.12 Presently, as set out above, the Claimants could have raised their contractual claims before the contractually agreed arbitral tribunals. Instead, when the Republic terminated the Subsoil Use Contracts and Contract No. 302, the Claimants never even thought of doing so. Only 5 days after the termination, the Claimants initiated the present arbitration under the ECT. For this reason alone, any contract claims brought under the umbrella clause must be considered inadmissible.

The Claimants acted in accordance with domestic law and with the contracts

³⁶¹ Noble Ventures, Inc. v. Romania, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 61 (**Exhibit R-66**).

³⁶² See paragraphs 33.18 to 33.21.

³⁶³ Cf. Newcombe/Paradell, *Law and Practice of Investment Treaties: Standards of Treatment*, p.472 (**Exhibit R-60**), referring to the case of *SGS v. Philippines*.

³⁶⁴ *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/02/6, Decision on Objections to Jurisdiction, 29 January 2004, paragraph 154 (**Exhibit C-282**).

³⁶⁵ Bureau Veritas, Inspection, Valuation, Assessment and Control, *BIVAC B.V. v. Republic of Paraguay*, ICSID Case No. ARB/07/9, Decision of the Tribunal on Objections to Jurisdiction, 29 May 2009, paragraph 153. (**Exhibit R-184**)

³⁶⁶ Douglas, *Hybrid Foundations of Investment Treaty Arbitration*, (2003) 74 BYIL 151 at 288-289 (**Exhibit R-185**)

39.13 The Republic's argument under the umbrella clause further fails because the Claimants at all times complied with domestic law, with the Subsoil Use Contracts and with Contract No. 302. In that regard, the Claimants refer to their submissions made above.

40 Effective Means of Asserting Claims and Enforcing Rights

40.1 A further guarantee invoked by the Claimants is contained in Article 10(12) ECT. According to this provision

"Each Contracting Party shall ensure that its domestic law provides effective means for the assertion of claims and the enforcement of rights with respect to Investments, investment agreements, and investment authorizations."

40.2 With regard to this guarantee, it is again the case that the availability of remedies hinders any claim if these remedies have not been pursued. The tribunal in the *Chevron* case, which dealt with a comparable clause in the US/Ecuador BIT, firmly held that

"in the consideration of whether the means provided by the State to assert claims and enforce rights are sufficiently "effective" [...], the Tribunal must consider whether a given claimant has done its part by properly using the means placed at its disposal. A failure to use these means may preclude recovery if it prevents a proper assessment of the "effectiveness" of the system for asserting claims and enforcing rights."³⁶⁷

40.3 The tribunal further stated that

"a high likelihood of success of these remedies is not required in order to expect a claimant to attempt them."³⁶⁸

40.4 Hence, the Claimants cannot invoke this provision in the present case. As explained above,³⁶⁹ the Claimants could have turned to the courts or to the contractually agreed arbitral tribunals. They largely did not do so and insofar as they did turn to the courts, they did not pursue all available appeals. This bars their bringing of a claim under Article 10(12) ECT.

40.5 Moreover, even if the Claimants could base their claim on the decisions of the Republic's courts, their claim would equally fail. As set out above, all of these court decisions were perfectly legal. In particular, it is beyond doubt that the Kazhak courts provided Mr. Cornegruta and the Claimants with effective means for making their legal case. As the Claimants SoC shows, KPM and TNG made numerous references to the Kazakh courts. Notwithstanding this they failed to ever exhaust

³⁶⁷ Chevron Corporation (USA) and Texaco Petroleum Company (USA) v. The Republic of Ecuador (**Exhibit C-285**),

³⁶⁸ *Ibid.*, paragraph 326.

³⁶⁹ See paragraphs 33.6 to 33.16.

all rights of appeal by going to the Supreme Court. Moreover, it was legally correct and not to KPM's disadvantage that it was not party to the proceedings

- 40.6 In addition, even if there had been mistakes in the proceedings, this would as such not entail the Republic's international responsibility. Under Article 10(12) ECT, a tribunal's review of local court decisions is limited. It was again the tribunal in *Chevron* that determined:

*"The Tribunal thus finds that it may directly examine individual cases under [the assertion of claims clause of the BIT], while keeping in mind that the threshold of "effectiveness" stipulated by the provision requires that a **measure of deference be afforded to the domestic justice system; the Tribunal is not empowered by this provision to act as a court of appeal reviewing every individual alleged failure of the local judicial system de novo.**"*³⁷⁰

- 40.7 In that regard, the Republic finds it most surprising that the Claimants actually invoke the *Chevron* case for the opposing proposition that it "falls to the Tribunal to step into the shoes of the Ecuadorian courts and decide the merits of the cases as it determines a fair and impartial judge in Ecuador would have decided the matter."³⁷¹ This statement of the *Chevron* tribunal is taken out of context. It was made in relation to causation and damages. After the tribunal had determined that the assertion of claims clause had been breached because of extensive delays, the tribunal merely stated that it could only find that the claimants had suffered damage if it could establish that a timely decision of the Ecuadorian courts would have been favourable to the claimants in the case. Thus, the *Chevron* tribunal clearly did not assume the position of an Ecuadorian judge in its finding of whether the assertion of claims clause had been breached.

³⁷⁰ Ibid, paragraph 247 (emphasis provided).

³⁷¹ SoC, paragraph 376, citing *Chevron Corporation (USA) and Texaco Petroleum Company (USA) v. The Republic of Ecuador*, PCA Case No. 34877, Partial Award on the Merits, 30 March 2010, paragraph 379 (**Exhibit C-285**).

41 No Impairment Through Unreasonable or Discriminatory Measures

41.1 Article 10(1) ECT further protects investors from State conduct that is unreasonable or discriminatory:

“[...] Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal.”

41.2 Presently, the Republic has acted in accordance with this guarantee. The Republic has always treated the Claimants in a reasonable and in a non-discriminatory way. Even if there had been instances of unreasonable or discriminatory conduct, these did not impair the “management, maintenance, use, enjoyment or disposal” of the Claimants’ investment.³⁷²

Unreasonable measures

41.3 The Republic’s actions were reasonable in each and every instance.

41.4 Protection against “unreasonable” measures is one of the standard guarantees of international investment law, provided for in practically every investment treaty. The precise wording of the guarantee varies, in that some treaties refer to measures that are “unjustified” or “arbitrary”. There is, however, no relevant distinction between the terms “unreasonable”, “unjustified” and “arbitrary” so these differences in wording have no bearing on the scope of the guarantee.³⁷³

41.5 It is clear from investment tribunal practice that a finding of a breach of the guarantee requires a high threshold. The classic interpretation of the guarantee was given by the ICJ in the *ELSI* case. With regard to the US/Italy FCN which used the term “arbitrary”, the court held that

*“Arbitrariness is not so much something opposed to a rule of law, but something opposed to the rule of law. [...] It is a wilful disregard of due process of law, **an act which shocks, or at least surprises, a sense of judicial propriety.**”³⁷⁴*

41.6 Further, the court clarified that mere breaches of domestic law or contract as such cannot lead to a breach of the guarantee.

³⁷² Claimants only submitted arguments regarding impairment by unreasonable or discriminatory measures. However, at SoC, paragraph 354, fn. 560, Claimants suggest that the Republic also violated the national and the most-favoured nation treatment provision in Article 10(7) ECT without developing the argument further. For the avoidance of doubt: The Republic categorically rejects that it breached Article 10(7) ECT.

³⁷³ Cf. Schreuer, Protection against Arbitrary or Discriminatory Measures (**Exhibit R-180**).

³⁷⁴ Elettronica Sicula S.p.A. (ELSI), Judgment (20 July 1989), I.C.J. Reports 1989, p.15, paragraph 128 (emphasis provided) (**Exhibit R-81**).

“[B]y itself, and without more, unlawfulness cannot be said to amount to arbitrariness. [...] To identify arbitrariness with mere unlawfulness would be to deprive it of any useful meaning in its own right.”³⁷⁵

- 41.7 Investment tribunals have frequently relied on the high threshold established in *ELSI*.³⁷⁶ In that regard, the ICJ’s definition has even been called “the most authoritative interpretation of international law”.³⁷⁷
- 41.8 A further example for the high threshold required for the finding of a breach of the guarantee is the *CME* case, invoked by the Claimants.³⁷⁸ In this case, the tribunal based its finding of “unreasonable” measures on the host State’s intention to deprive the investor of its investment.³⁷⁹ Thus, in this case, it was the host State’s outright bad faith that caused the tribunal to determine that there had been “unreasonable” measures.
- 41.9 Against this background, none of the Republic’s actions can be deemed “unreasonable”:
- 41.10 The Claimants first complain that the classification of their pipelines as “trunk pipelines”, the ensuing trial of Mr. Cornegruta, the verdict and fine against KPM and the following “freezing” of KPM’s assets were unreasonable.³⁸⁰ Yet, this claim fails for the simple reason that all of these measures were taken out in accordance with the Republic’s laws and with the aim of rectifying The Claimants’ own breaches of the law. The Claimants had operated trunk pipelines without a licence, a fact which was confirmed by the Republic’s independent courts. This fact warranted criminal proceedings and the imposing of a fine. The fine was not unreasonable but based on the court’s proper assessment of the due amount. Moreover, the Republic only took enforcement measures and “froze” KPM’s assets upon non-payment of the fine, which is a perfectly reasonable course of action.
- 41.11 In any event, even if there had been some mistakes in the application of the law, which the Republic categorically denies, this would not mean that the Republic had acted unreasonably. If there had been some incorrect assessment of the technical matters regarding the pipelines, this would clearly not shock or surprise a sense of judicial propriety.
- 41.12 Further, contrary to what the Claimants suggest,³⁸¹ the Republic’s actions with regard to the transfer of TNG to Terra Raf were also reasonable. The Republic was completely free in its decision of whether to approve this transfer. Not being legally bound in any way, both an

³⁷⁵ *Electronica Sicula S.p.A. (ELSI)*, Judgment (20 July 1989), I.C.J. Reports 1989, p.15, paragraph 124 (**Exhibit R-81**).

³⁷⁶ Cf. e.g. *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 176 (**Exhibit R-66**);

LG&E v. Argentina, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, paragraph 157. (**Exhibit R-63**)

³⁷⁷ *Siemens A.G. v. Argentine Republic*, ICSID Case No. ARB/02/8, Award, 6 February 2007, paragraph 318 (**Exhibit C-232**).

³⁷⁸ SoC, paragraph 357.

³⁷⁹ *CME Czech Republic B.V. v. Czech Republic*, Partial Award, 13 September 2001, paragraph 612 (**Exhibit C-229**).

³⁸⁰ SoC, paragraph 362, 1st bullet point.

³⁸¹ SoC, paragraph 362, 3rd bullet point.

approval and a disapproval would have been reasonable. Moreover, the Claimants cannot argue that the Republic unreasonably revoked its approval, simply because the Claimants have not shown that the Republic had ever approved of the transfer. In any event, even if there had been an approval, a revocation thereof would have been reasonable, given that the Claimants had wrongly informed the Republic of the details of the transfer.

- 41.13 Likewise, the Republic also acted completely reasonably in not prolonging the exploration rights under Contract No. 302.³⁸² The Republic was again completely free in this decision. The fact that it did not prolong the exploration rights thus cannot be deemed unreasonable. Moreover, the Claimants could not reasonably rely on the fact that the exploration would be prolonged so long as the Republic had not signed the necessary addendum.
- 41.14 The Claimants' allegations with regard to tax assessments³⁸³ likewise fail. As explained above, the Republic's assessment of back taxes was in compliance with domestic law. Given the incorrect invocation of tax deductions by the Claimants, the Republic's back tax assessment was entirely reasonable. Likewise, the Kazakh courts legitimately determined that KPM was liable to pay the export tax imposed on it in accordance with the law.
- 41.15 In any event, even if there had been incorrect tax assessments, this would as such not give rise to unreasonableness. The Claimants seem to argue that any time a State holds a position not in line with its contractual agreements, it acts unreasonably and thus breaches international law. This can clearly not have been the intention of the States party to the ECT.
- 41.16 In addition, no fault can be found with regard to the termination of the contracts.³⁸⁴ There were valid grounds for a lawful termination of these contracts and the Republic simply exercised its right to terminate.
- 41.17 Finally, it must be reiterated that the Republic did not have the intention of depriving the Claimants of their investments and that there was no campaign of harassment.³⁸⁵ Thus, no unreasonableness follows from an intentional deprivation of the investment, as was the case in *CME*.

Discriminatory measures

- 41.18 The Republic never discriminated against the Claimants.

The Claimants somewhat unclearly describe the standard of discrimination as requiring "a differential treatment applied to people who are in similar situations" and argue that there has to

³⁸² Cf. SoC, paragraph 362, 4th bullet point.

³⁸³ SoC, paragraph 362, 5th and 6th bullet point.

³⁸⁴ SoC, paragraph 362, 7th bullet point.

³⁸⁵ SoC, paragraph 357.

be a “rational justification for any differential treatment of a foreign investor.”³⁸⁶ Such unclear description is not necessary, given that the tribunal in *Saluka* developed a very simple definition:

*“State conduct is discriminatory, if (i) similar cases are (ii) treated differently (iii) and without reasonable justification.”*³⁸⁷

- 41.19 Importantly, in line with the general “onus probandi” rule, the burden of proof for the similarity of the cases and the differential treatment lies with the Claimants. This is for example evidenced by *BG v. Argentina*, in which the tribunal rejected a claim for discrimination because it found that the similarity of cases had not been sufficiently established.³⁸⁸ Moreover, the tribunal also rejected the discrimination claim because of a lack of proof regarding the differential treatment - with the words of the tribunal: “it is not apparent that Argentina’s measures were ‘not taken under similar circumstances against another national.’”³⁸⁹
- 41.20 The tribunal in *Nykomb v. Latvia (Exhibit C-281)*, interpreting Article 10(1) ECT, came to the same conclusion. Only after the tribunal had deemed established that there were like circumstances and that there was differential treatment did it find that the burden of proof had shifted and that it was now for the Republic to show that there was a reasonable justification for the differential treatment.³⁹⁰
- 41.21 Presently, the Claimants base their claim of discrimination on the classification of KPM’s and TNG’s pipelines as “trunk pipelines” and the ensuing criminal proceedings. Yet, the Claimants have completely failed to prove that there were similar cases and that these were treated differently.
- 41.22 To begin with, the investigation into the pipelines issue was not discriminatory. In that regard, it is important to note that KPM’s and TNG’s pipelines were not “reclassified”, as the Claimants allege.³⁹¹ Rather, the Financial Police discovered that the pipelines were “trunk pipelines” and upon investigation found out that KPM and TNG did not have the necessary licences. The treatment of KPM and TNG was thus no different to that of any other company where such infringement was found or would have been found. The Republic’s authorities simply did what they had to do under the Republic’s laws.
- 41.23 Importantly, the Claimants failed to provide evidence of any case in which the Republic’s authorities did not step in when they had reason to believe that there were “trunk pipelines” being

³⁸⁶ SoC, paragraph 359, quoting *Goetz v. Burundi (Exhibit C-227)* and *Saluka v. Czech Republic (Exhibit C-259)*.

³⁸⁷ *Saluka Investments BV (The Netherlands) v. The Czech Republic, Partial Award*, 17 March 2006, paragraph 313 (**Exhibit C-259**).

³⁸⁸ *BG Group Plc v. Argentina, Award*, 24 December 2007, paragraph 357 (**Exhibit C-268**).

³⁸⁹ *BG Group Plc v. Argentina, Award*, 24 December 2007, paragraph 359 (**Exhibit C-268**).

³⁹⁰ *Nykomb Synergetics Technology Holding AB v. Latvia, SCC, Award*, 16 December 2003, paragraph 4.3.2, lit. a (**Exhibit C-281**).

³⁹¹ SoC, paragraph 362, 2nd bullet point.

operated without a licence. In particular, contrary to what the Claimants argue,³⁹² the pipelines of neighbouring companies do not support the Claimants' position. The Claimants have not put forward any evidence that the neighbouring pipelines are trunk pipelines. In fact, the Claimants undermine their own argument in this regard because the comparable factors they cite are not relevant to the question of whether a pipeline is a trunk pipeline.³⁹³

- 41.24 It should be added that also with regard to the conviction of Mr. Cornegruta and the fine against KPM, there was no discrimination. The Claimants have not shown any case in which the authorities did not initiate criminal proceedings as a reaction to the operation of "trunk pipelines" without a licence.

Impairment

- 41.25 In any event, the Republic's measures did not impair the Claimants' management, maintenance, use, enjoyment or disposal of KPM and TNG.
- 41.26 Again, it is for the Claimants to prove that there was any actual impairment of their investment through the Republic's measures. However, the Claimants have not even made the most rudimentary attempts at doing so. In particular, the Claimants have not tried to discern the effects of the Republic's actions from the effects of the Claimants' own poor management of KPM and TNG. This alone is fatal to the Claimants' claim.
- 41.27 To begin with, the Claimants did not explain how the classification of the pipelines as "trunk pipelines", the trial and conviction of Mr. Cornegruta and the fine against KPM affected KPM's and TNG's management, maintenance, use, enjoyment or disposal. It stands to reason that companies the size of KPM and TNG must be able to deal with such investigations, in particular if these investigations are only the result of the companies' own wrongdoing. In any event, the Claimants must show how their daily management activities were affected, whether there was a cut in dividends and how and why the Claimants could no longer dispose of KPM and TNG. They have not done so.
- 41.28 Moreover, it remains completely unclear how KPM and TNG were affected by the dispute about the Republic's alleged approval of TNG's transfer to Terra Raf. The mere assertion that the Claimants were impaired in their ability to market KPM and TNG to potential buyers is not sufficient.³⁹⁴ The Claimants have to show specific sales prospects which ceased to exist due to the dispute.

³⁹² SoC, paras. 87, 362, 2nd bullet point.

³⁹³ Paragraph 23.19(d)

³⁹⁴ SoC, paragraph 362, 3rd bullet point.

- 41.29 Lastly, no impairment follows from the refusal to extend the exploration period under Contract No. 302, the back tax assessments and the imposition of export taxes.³⁹⁵ In all of these instances, KPM and TNG had no right and no advantage taken from them. From the very beginning, KPM and TNG could not expect that the exploration period under Contract No. 302 would be extended because the Republic was free to decide whether it wanted to prolong the contract. Likewise, the Claimants could not expect that no back taxes would be assessed and that the export tax would not be imposed. The Republic was entitled to the payment of these taxes.
- 41.30 All in all, the Claimants have thus not established that there were any adverse effects. They can hence not argue that the Republic impaired their management, maintenance, use, enjoyment or disposal of KPM and TNG through unreasonable or discriminatory measures.

42 Observance of Obligations

- 42.1 The Claimants can further not base their claims on the Republic's duty to "observe any obligations it has entered into with an Investor or an Investment of an Investor" under the last sentence of Article 10(1) ECT. This "umbrella clause" does not create any liability for the Republic. Firstly, the umbrella clause does not extend to obligations arising out of a host State's domestic law. Secondly, the exclusive dispute resolution clauses in the Subsoil Use Contracts and Contract No. 302 bar the Claimants from bringing alleged violations of these contracts to this Tribunal. Thirdly and in any event, the Republic acted at all times in accordance with its domestic law and with the Subsoil Use Contracts.

The umbrella clause does not extend to obligations in the Republic's domestic law

- 42.2 Large parts of the Claimants' case with regard to the umbrella clause are based on alleged breaches of the Republic's domestic law. Yet, the umbrella clause does not allow the Claimants to rely on alleged violations of domestic law before this Tribunal. The wording of the umbrella clause clearly shows that the effect of the umbrella clause is limited to contractual obligations. Investment case law further bolsters this position.
- 42.3 As to the wording, it is important to note that according to its Article 50, the ECT has six authentic languages: English, French, German, Italian, Russian and Spanish. The texts in all five languages are clear in limiting the scope of the umbrella clause to obligations stemming from contracts. The French and Spanish versions even contain the respective verbs for the noun "contract":

³⁹⁵ SoC, paragraph 362, 4th, 5th, 6th and 7th bullet point.

*“Chaque partie contractante respecte les obligations qu'elle a **contractées** vis-à-vis d'un investisseur ou à l'égard des investissements d'un investisseur d'une autre partie contractante.”*

*“Toda Parte Contratante cumplirá las obligaciones que haya **contraído** con los inversores o con las inversiones de los inversores de cualquier otra Parte Contratante.”*

- 42.4 Likewise, the English, Italian and Russian versions of the text are clear in pointing out that the relevant obligations must be “entered into” or “assumed with regard to” the investor or investment. This also shows that only obligations stemming from a contract are relevant.

*“Each Contracting Party shall observe any obligations it has **entered into with an Investor** or an Investment of an Investor of any other Contracting Party”*

*“Ciascuna Parte contraente adempie eventuali obblighi **assunti riguardo ad un investitore** o un investimento effettuato da un investitore di una qualsiasi altra Parte contraente.”*

*“Jede Vertragspartei erfüllt alle Verpflichtungen, die sie **gegenüber einem Investor oder einer Investition eines Investors** einer anderen Vertragspartei **eingegangen** ist.“*

“Каждая Договаривающаяся Сторона соблюдает все обязательства, которые она приняла в отношении Инвестора или Инвестиции Инвестора любой другой Договаривающейся Стороны.”

- 42.5 In this regard, the ECT is clearly in line with the practice of investment treaties in general. Umbrella clauses in other BITs generally do not extend to obligations contained in the host State's domestic law.
- 42.6 Investment tribunals have been very reluctant to extend the scope of umbrella clauses to domestic law. The tribunal in *Al-Bahloul v. Tajikistan*, when dealing with the present umbrella clause under the ECT, was firm in holding that it “does not refer to general obligations of the State arising as a matter of law.”³⁹⁶
- 42.7 Moreover, in the handful of cases involving Argentina, in which other contractual obligations were found to fall under the scope of the umbrella clause, this was due to some very specific circumstances. Argentina had enacted specific legislation targeting investors and had advertised the guarantees contained in this legislation in “offering memorandums” which were addressed to the investors. It was only for this reason that the Tribunals in *LG&E* and *Enron* (a case

³⁹⁶ Mohammad Ammar Al-Bahloul v. Republic of Tajikistan, SCC Case No. V (064/2008), Partial Award on Jurisdiction and Liability, 2 September 2009, paragraph 257. (**Exhibit R-181**)
Cf. also CMS Gas Transmission Company v. The Argentine Republic, ICSID Case No. ARB/01/8, Annulment Decision, 25 September 2007, paragraph 95, lit. a. (**Exhibit R-182**)

surprisingly cited by the Claimants in their favour) came to the conclusion that the umbrella clause extended to the specific obligations contained in the advertised legislation.³⁹⁷ In the present case, there clearly was no such targeting of foreign investors by the Republic.

- 42.8 To be clear: There is no reported case in which the scope of the umbrella clause was extended to domestic law unconditionally. The wording of the ECT clearly speaks against any attempts to do so in the present case. The Claimants' claims of violations of domestic law under the umbrella clause fail for this ground alone.

The Claimants also cannot bring claims for breach of contract under the umbrella clause

- 42.9 The Claimants' reliance on the umbrella clause is equally misplaced with regard to the alleged breaches of the Subsoil Use Contracts and Contract No. 302. While breaches of contract can generally fall under the scope of the umbrella clause,³⁹⁸ the Claimants are barred from invoking these contracts because they contain exclusive arbitration clauses.³⁹⁹ The Claimants never initiated arbitration under any of these arbitration clauses.
- 42.10 Investment tribunals have been firm in insisting that claims under an umbrella clause cannot be brought so long as the requirements of an exclusive forum selection clause have not been complied with. The rationale behind this is simple: By including forum selection clauses in their contracts, the investor and the host State agree to tie the material obligations of the contract to the resolution in a certain forum. To allow an investor to bring a contract claim by way of an investment treaty would thus breach the principle of *pacta sunt servanda*.⁴⁰⁰ As a consequence, as long as the process in the selected forum is not gone through, claims arising from the contract are simply not ripe for arbitration under an investment treaty. As the tribunal in *SGS v. Philippines* put it:

“The question is whether a party should be allowed to rely on a contract as the basis of its claim when the contract itself refers that claim exclusively to another forum. In the Tribunal’s view the answer is that it should not be allowed to do so, unless there are good reasons, such as force majeure, preventing the claimant from complying with its contract. This impediment, based as it is on the principle that a party to a contract cannot claim on

³⁹⁷ LG&E v. Argentina, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, paragraph 175 (**Exhibit R-63**); Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic, ICSID Case No. ARB/01/3, Award, 22 May 2007, paras. 264, 275 (cited at SoC, paragraph 370) (**Exhibit C-263**).

Cf. also the case of Continental Casualty Company v. Argentina, ICSID Case No. ARB/03/9, Award, 5 September 2008, paras. 300 et seq. (**Exhibit R-183**), in which the tribunal rejected considering domestic law under the umbrella clause precisely because there was no specific targeting of investors.

³⁹⁸ Noble Ventures, Inc. v. Romania, ICSID Case No. ARB/01/11, Award, 12 October 2005, paragraph 61 (**Exhibit R-66**).

³⁹⁹ Cf. supra 33.18 to 33.21.

⁴⁰⁰ Cf. Newcombe/Paradell, Law and Practice of Investment Treaties: Standards of Treatment, p.472 (**Exhibit R-60**), referring to the case of *SGS v. Philippines*.

*that contract without itself complying with it, is more naturally considered as a matter of admissibility than jurisdiction.*⁴⁰¹

42.11 This position was later adopted by the tribunal in *BIVAC v. Paraguay*⁴⁰² and also found support among commentators.⁴⁰³

42.12 Presently, as set out above, the Claimants could have raised their contractual claims before the contractually agreed arbitral tribunals. Instead, when the Republic terminated the Subsoil Use Contracts and Contract No. 302, the Claimants never even thought of doing so. Only 4 days after the termination, the Claimants initiated the present arbitration under the ECT. For this reason alone, any contract claims brought under the umbrella clause must be considered inadmissible.

The Claimants acted in accordance with domestic law and with the contracts

42.13 The Republic's argument under the umbrella clause further fails because the Claimants at all times complied with domestic law, with the Subsoil Use Contracts and with Contract No. 302. In that regard, the Claimants refer to their submissions made above.

43 Effective Means of Asserting Claims and Enforcing Rights

43.1 A further guarantee invoked by the Claimants is contained in Article 10(12) ECT. According to this provision

“Each Contracting Party shall ensure that its domestic law provides effective means for the assertion of claims and the enforcement of rights with respect to Investments, investment agreements, and investment authorizations.”

43.2 With regard to this guarantee, it is again the case that the availability of remedies hinders any claim if these remedies have not been pursued. The tribunal in the *Chevron* case, which dealt with a comparable clause in the US/Ecuador BIT, firmly held that

“in the consideration of whether the means provided by the State to assert claims and enforce rights are sufficiently “effective” [...], the Tribunal must consider whether a given claimant has done its part by properly using the means placed at its disposal. A failure to use these means may preclude recovery if it prevents a proper assessment of the “effectiveness” of the system for asserting claims and enforcing rights.”⁴⁰⁴

43.3 The tribunal further stated that

⁴⁰¹ SGS Société Générale de Surveillance S.A. v. Republic of the Philippines, ICSID Case No. ARB/02/6, Decision on Objections to Jurisdiction, 29 January 2004, paragraph 154 (**Exhibit C-282**).

⁴⁰² Bureau Veritas, Inspection, Valuation, Assessment and Control, BIVAC B.V. v. Republic of Paraguay, ICSID Case No. ARB/07/9, Decision of the Tribunal on Objections to Jurisdiction, 29 May 2009, paragraph 153. (**Exhibit R-184**)

⁴⁰³ Douglas, Hybrid Foundations of Investment Treaty Arbitration, (2003) 74 BYIL 151 at 288-289 (**Exhibit R-185**)

⁴⁰⁴ Chevron Corporation (USA) and Texaco Petroleum Company (USA) v. The Republic of Ecuador (**Exhibit C-285**),

“a high likelihood of success of these remedies is not required in order to expect a claimant to attempt them.”⁴⁰⁵

- 43.4 Hence, the Claimants cannot invoke this provision in the present case. As explained above,⁴⁰⁶ the Claimants could have turned to the courts or to the contractually agreed arbitral tribunals. They largely did not do so and insofar as they did turn to the courts, they did not pursue all available appeals. This bars their bringing of a claim under Article 10(12) ECT.
- 43.5 Moreover, even if the Claimants could base their claim on the decisions of the Republic’s courts, their claim would equally fail. As set out above, all of these court decisions were perfectly legal. In particular, it is beyond doubt that the Kazhak courts provided Mr. Cornegruta and the Claimants with effective means for making their legal case. As the Claimants SoC shows, KPM and TNG made numerous references to the Kazakh courts. Notwithstanding this they failed to ever exhaust all rights of appeal by going to the Supreme Court. Moreover, it was legally correct and not to KPM’s disadvantage that it was not party to the proceedings
- 43.6 In addition, even if there had been mistakes in the proceedings, this would as such not entail the Republic’s international responsibility. Under Article 10(12) ECT, a tribunal’s review of local court decisions is limited. It was again the tribunal in *Chevron* that determined:

*“The Tribunal thus finds that it may directly examine individual cases under [the assertion of claims clause of the BIT], while keeping in mind that the threshold of “effectiveness” stipulated by the provision requires that a **measure of deference be afforded to the domestic justice system; the Tribunal is not empowered by this provision to act as a court of appeal reviewing every individual alleged failure of the local judicial system de novo.**”⁴⁰⁷*

- 43.7 In that regard, the Republic finds it most surprising that the Claimants actually invoke the *Chevron* case for the opposing proposition that it “falls to the Tribunal to step into the shoes of the Ecuadorian courts and decide the merits of the cases as it determines a fair and impartial judge in Ecuador would have decided the matter.”⁴⁰⁸ This statement of the *Chevron* tribunal is taken out of context. It was made in relation to causation and damages. After the tribunal had determined that the assertion of claims clause had been breached because of extensive delays, the tribunal merely stated that it could only find that the claimants had suffered damage if it could establish that a timely decision of the Ecuadorian courts would have been favourable to the claimants in the case. Thus, the *Chevron* tribunal clearly did not assume the position of an Ecuadorian judge in its finding of whether the assertion of claims clause had been breached.

⁴⁰⁵ Ibid., paragraph 326.

⁴⁰⁶ Cf. supra paragraph 33.6 to 33.16.

⁴⁰⁷ Ibid, paragraph 247 (emphasis provided).

⁴⁰⁸ SoC, paragraph 376, citing *Chevron Corporation (USA) and Texaco Petroleum Company (USA) v. The Republic of Ecuador*, PCA Case No. 34877, Partial Award on the Merits, 30 March 2010, paragraph 379 (**Exhibit C-285**).

PART 4: QUANTUM**44 No compensation or damages**

44.1 The Claimants assert that they are entitled to compensation and/or damages of a total of 2 billion 764 million US dollars in comprising the following amounts:

- (i) Borankol Field: 193 million US dollars;
- (ii) Tolkyn Field: 561 million US dollars;
- (iii) LPG Plant: 344 million US dollars (in the alternative, 208,5 million US dollars); and
- (iv) Contract No. 302 Properties: 1, 766 million US dollars,

together with an amount in respect of damages and interest.

44.2 The Republic's position is that no compensation or damages should be awarded on a number of bases.

44.3 Firstly and fatally, the Claimants have failed to establish jurisdiction in this arbitration.

44.4 Secondly, the Claimants have failed demonstrate that the Republic is in breach of its obligations under the ECT, contrary to their assertion at paragraph 384 of the Statement of Claim. As already asserted and for all the reasons set out herein:

- (a) It is denied (as alleged at paragraph 385 of the Statement of Claim and throughout) that the termination of TNG's and KPM's contracts together with the taking into trust management of KPM's and TNG's assets (a) constituted direct expropriation and / or (b) constituted direct expropriation for which compensation is owed.
- (b) It is denied (as alleged at paragraph 386 of the Statement of Claim and throughout) that President Nazarbayev's order of 14 October 2008 initiated a "lengthy series of unlawful State acts" of which the alleged direct expropriation formed the last.
- (c) It is, therefore, denied that there was any unlawful expropriation of the Claimants' alleged investment (as alleged in paragraph 387 of the Statement of Claim and throughout).
- (d) As to paragraph 388 of the statement of claim, while it is accepted that the Claimants' case is that there were 8 indicative offers for the Tolkyn fields and their assets, it is denied that this leads to the conclusion that there is a "*factual record of the actual reaction of willing and able buyers to an offer of a portion of Claimants' investments by a willing and able seller...each having reasonable knowledge of the relevant facts.*" Rather, the offers referred to were non-binding, based on limited information and, once further

information was received resulted in those offers being revoked. Further, given the problems with the legality of the titles that the seller was seeking to dispose of, it is far from the case that the seller in this case was “an able seller”. The indicative offers that the Claimants received for the Tolwyn and Borankol fields prior to 14 October 2008 are irrelevant to the valuation of KPM and TNG.

- 44.5 Thirdly, it is denied that the Republic has directly or indirectly expropriated any of the assets alleged nor is the Republic in breach of any of its obligations under the ECT.
- 44.6 Any analysis of the Claimants’ claim for compensation is therefore solely on the alternative basis that the Tribunal finds a compensable expropriation or another breach of the ECT, since it is the Claimants’ position that the Arbitral Tribunal should not need to consider compensation at all.

45 Legal sources of measures of damages and compensation for expropriation

- 45.1 The Claimants’ assertions as to the legal premise for compensation are set out in paragraphs 389 to 403 of the Statement of Case.
- 45.2 At paragraphs 389 and 392 of the Statement of Case, the Claimants rightly state that article 13 of the ECT provides for two kinds of withdrawal of property by a host State: lawful and unlawful expropriation. In respect of lawful expropriation (and as set out above), compensation is one of the five criteria that render an expropriation lawful. If expropriation is carried out with public purpose without discrimination and with observation of due legal procedures, together with prompt, adequate and effective compensation it is deemed to be lawful. In this context, “*compensation*” is differentiated from damages since the obligation of payment “*does not emanate from an unlawful act of a State but from a legitimate exercise of State sovereignty.*”⁴⁰⁹
- 45.3 As to the relevant test for a lawful expropriation, the Claimants correctly identify that the standard of compensation is the “*fair*” market value of a qualifying investment. [The Claimants’ definition of “fair market value” in fact relies on the American Society of Appraisers’ definition of “market value” a corresponding valuation standard. The Republic does not challenge the content of this definition, although it is not admitted that this is the definition for “fair market value”. The Republic refers and relies on the International Valuation Standards (IVS) definition which states that: “*Market Value is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compensation.*”

⁴⁰⁹ J. Marboe, *Calculation of Compensation and Damages in International Investment Law*, Oxford University Press (2009), p13. (Exhibit R-40)

- 45.4 As to unlawful actions in breach of the ECT (including unlawful expropriation), it is accepted that the measure of damages will be established by general principles of international law.
- 45.5 It is noted that the Claimant specifically does not request for restitution in kind, i.e. – it does not wish to return its Investments in material substantial form. It requests to be compensated the value of expropriated investments in monetary equivalent as well as to be compensated for damages and be paid interest.

46 Limiting Factors on Recovery

- 46.1 While at all times it is for the Claimants to prove their case on damages in the usual way, with the exception of paragraphs 397 to 399 and the last sentence of 403 (which deals with lost profits and non-material damages and which are dealt with below) the Republic takes no particular issue with the trite statements of law set out in paragraphs 389 of the Statement of Claim. However, the Claimants have failed to annunciate or deal adequately with the clear limiting factors that apply to the recovery of damages under international law.
- 46.2 The Claimants point, at paragraph 429 of the Statement of Claim, to a useful passage in *Lemire v Ukraine* that articulates at least two of the key limiting factors in relation to the recovery of damages under international law. Firstly, “*damages must not be speculative or uncertain but proved with reasonable certainty*” and secondly that causation needs to be established and a proven loss needs to be demonstrated. (It is not denied that that, as Lemire goes on to say, once these factors have been demonstrated, the extent of the loss itself does not necessarily have to be established to the same level of certainty).

i) No loss

- 46.3 The Claimants have failed to adequately plead loss attributable to any of the Claimants. Instead they describe the effect of the alleged actions in relation to four of the assets that the Claimants asserts are “Investments” within the meaning of the ECT.
- 46.4 Instead of establishing and quantifying how each of the Claimants’ alleged investments have been affected by actions of the Republic, the Claimants rely on the generalized category of “the Claimants” and require the Arbitral Tribunal to establish how such loss affected the each of the Claimants. This is not an analysis for the Arbitral Tribunal to carry out.
- 46.5 This defect in the Claimants’ quantum claim is unsurprising given the Claimants’ failure in the first place to establish which alleged investors own or control which alleged investments. The Republic has already explained how this fundamental flaw undermines the Claimants’ claim from a jurisdictional perspective. The legal ramifications of this for the Claimants’ alleged entitlement to compensation and / or damages is that in effect, no loss has been alleged.

46.6 No mention at all is made as to the effect (if any) on the equity interests in KPM and TNG assets that the Claimants asserted were investments at paragraph 34 of the Statement of Claim.

ii) Failure to establish a causal link

46.7 The Claimants make no attempt to establish a causal link between the losses claimed and any of the alleged events of indirect expropriation or the alleged breaches of Article 10 of the ECT.

46.8 They simply present lump sum values in respect of three Subsoil Contract areas and an LPG plant in a manner which defies any attempt to attribute any portion of those alleged losses to any (or even all) of the alleged events of the alleged breaches of the ECT.

46.9 On this basis, the Arbitral Tribunal is apparently asked to believe that the audit by the Tax Committee in November 2009 alone caused a \$2.8bn reduction in the value of the Claimants investments. Clearly this is nonsense.

46.10 Whilst that is perhaps an extreme example, real practical problems result:

(a) The Claimants have failed to discharge its obligation to demonstrate a causal connection between alleged breaches of the ECT and the compensation it claims.

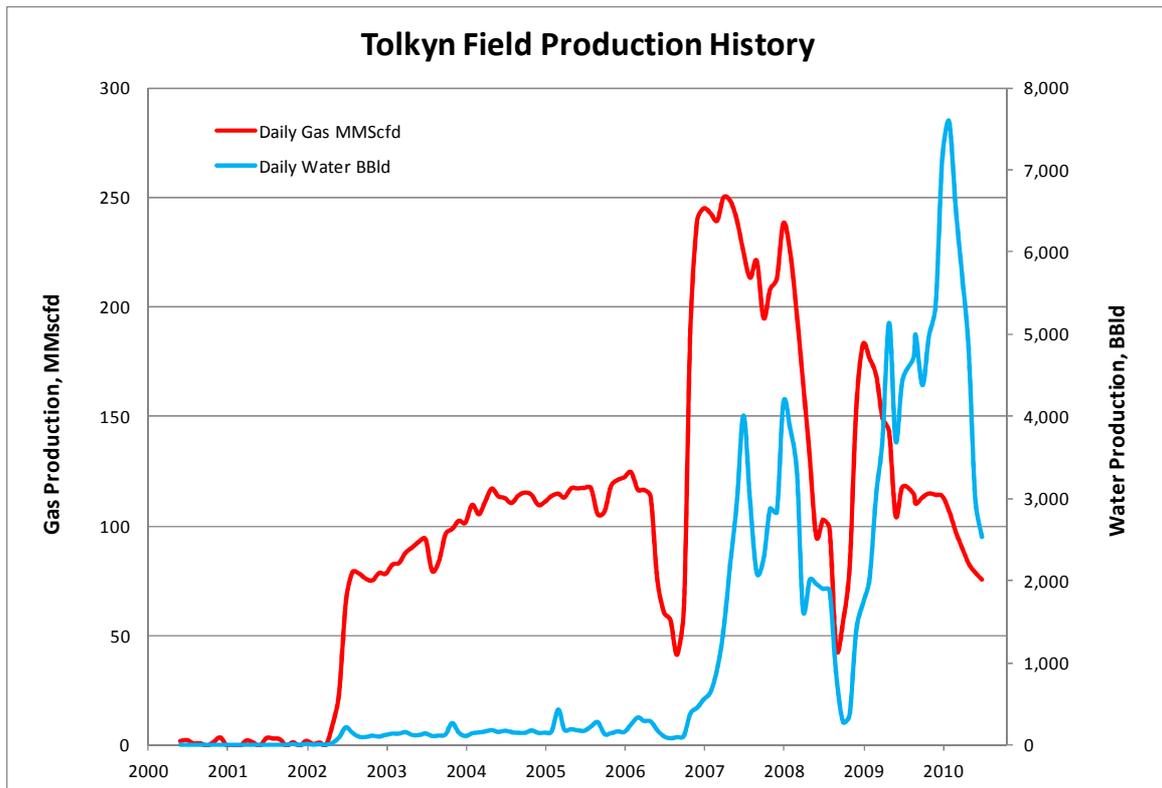
(b) Unless the Arbitral Tribunal finds for the Claimants in respect of each and every element of its claim, it has not way of calculating the appropriate amount of compensation, by reference to the relevant heads of claim.

46.11 Accordingly, even if the Arbitral Tribunal were to find that there were breaches of the ECT by the Republic (which is denied), it cannot award any of the compensation claimed to the Claimants, because there is no proof that the alleged losses flow from the alleged breaches.

46.12 Furthermore it is apparent that there are other possible causes of a reduction in the value of the Claimants investments that cannot possibly be attributable to the Republic and may even be attributable to the Claimants.

46.13 For instance, in 2008/2009 there was a dramatic increase in water production in the gas wells of TNG's Tolwyn field. This is referred to by GCA in paragraph 30 of their report as illustrated below:

TOLKYN FIELD - HISTORICAL GAS AND WATER PRODUCTION



(GCA Figure 2)

46.14 As can be seen from the above graph, this was accompanied by an equally dramatic reduction in the quantity of gas produce by the Tolken field, which was apparent even at 14 October 2008.

46.15 As GCA comment:

“The production of water into a gas well can lead to an immediate reduction in the productivity of the well, and ultimately to a reduction in the total volume of gas (and condensate) produced from the well

...

Gas production [at the Tolkyn field] was significantly increased in 2007...This increase in gas and condensate production was achieved by increasing individual well rates and not be drilling additional wells. This rapid increase in individual well rates may have accelerated water production.” (GCA paras 30 to 32)

46.16 The increased water production and corresponding decrease in gas production is noted as a factor in Deloitte's valuation:

“7.3 Following the increasing water cut the natural gas production significantly decreased in 2009 to 1.3 bln m3. In 1H 2010, the production decreased by 70% against the same period of 2008, while the amount of produced water increased by 80%. As of the Valuation Date, the Tolkyn field well-stock amounted to 34 wells, among which: 24 were producing water, 4 were idle and 6 were planned for abandonment

7.4 GCA projects natural gas output at Tolkyn field to retain its downward trend and to reduce 20% a year on the average, while the amount of extracted water will grow 10% annually. Given the high water cut, it is estimated that TNG will have to sidetrack 5 wells and to work over 6 wells which will require a total additional CapEx of USD 3.1 mln¹⁵. To project sales revenue we relied upon output forecast developed by GCA

...

7.7 To project Tolkyn sales revenue we relied upon output forecast developed by GCA. The details on Tolkyn sales revenue are presented in Appendices hereto.” (Deloitte’s paragraph 7.3, 7.4 & 7.7)

46.17 All other things being equal, sales revenue will reduce as production reduces. The valuation method for the Tolkyn field applied by both Deloitte and FTI will produce a lower fair market value as a result of reduced revenue and increased costs. It is therefore clear that the value of the Claimants investments has reduced in the period of the events of which the Claimants complain as a result of factors which have nothing to do with the Republic and which it seems likely were the result of the Claimants’ own actions.

46.18 Accordingly and in conclusion, the Arbitral Tribunal would be justified in having very real concerns as a result of the Claimants summary treatment of causation.

iii) Non recoverable loss: Speculative Lost Profits

46.19 The Claimants’ position in relation to loss of profits is, as would be expected, that these are recoverable. They cite the non-binding article 31 of the Draft ILC Articles as authority: *“The compensation shall cover any financially assessable damage including loss of profits insofar as it is established.”*

46.20 It is noted that this statement is narrowed by paragraph 27 of Article 36 of the same text (**Exhibit R-104**): *“... loss of profit have not been as commonly awarded in practice as compensation for accrued losses. Tribunals have been reluctant to provide compensation for claims with inherent speculative elements”.*

46.21 Investment tribunals have been very reluctant to award lost profits to investors. The threshold for proving damages resulting from the loss of profits has constantly been set very high. In particular, investment tribunals have regularly required a clear history of profitability which evidences that the alleged profits would have been very likely to occur. If the investor cannot show that his investment created profits over a certain period of time, his claim fails.

46.22 As the tribunal in *Metalclad v. Mexico* explained:

“[W]here the enterprise has not operated for a sufficiently long time to establish a performance record or where it has failed to make a profit, future profits cannot be used to determine going concern or fair market value.”⁴¹⁰

46.23 Other tribunals have been equally firm in requiring a record of profits and sufficiently certain economic projections. For example, in *Autopista v. Venezuela*, the tribunal stated

“ICSID tribunals are reluctant to award lost profits for a beginning industry and unperformed work. This reluctance of ICSID tribunals is confirmed by the practice of the Iran-U.S. Claims Tribunal.”⁴¹¹

46.24 In the following paragraph, the tribunal went on to reject the investor’s claim for lost profits because

“[I]n the present case, the fact remains that Aucoven had no record of profits and that it never made the investments in the project nor built the Bridge required by the Concession Agreement. In these circumstances, the Tribunal considers that Aucoven’s claim for future profits does not rest on sufficiently certain economic projections and thus appears speculative. Hence, it does not meet the standards for an award of lost profits under Venezuelan law, nor would it meet these standards under international law, if the latter were applicable.”⁴¹²

46.25 Likewise, the tribunal in *Wena Hotels v. Egypt* rejected a claim for lost profits *inter alia* because one of the hotels in question had been operated for less than eighteen months. Under these circumstances, the Tribunal did not see a sufficiently solid base for the assumption of a future profit.⁴¹³ Further, in *AAPL v. Sri Lanka*, the tribunal rejected a claim for lost profits of a newly formed company without a record of profits because future profitability could not be established

⁴¹⁰ *Metalclad Corp. v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award (30 August 2000), paragraph 120. (**Exhibit C-226**)

⁴¹¹ *Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB/00/5, Award (23 September 2003), paragraph 360 (**Exhibit R-42**).

⁴¹² *Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB/00/5, Award (23 September 2003), paragraph 362 (**Exhibit R-42**).

⁴¹³ *Wena Hotels Ltd. v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, Award (8 December 2000), paragraph 124 (**Exhibit C-216**).

*“with a sufficient degree of certainty.”*⁴¹⁴ Finally, the tribunal in *SPP v. Egypt* rejected a calculation of damages based on the DCF method, which uses expected future profits, *“because the project was not in existence for a sufficient period of time to generate the data necessary for a meaningful DCF calculation.”*⁴¹⁵

46.26 As to the Claimants’ reliance on Professor Gotanda’s analysis at paragraph 429 of the Statement of Claim to assert that in proving these lost profits, it is not necessary to prove such losses with “complete certainty” and that uncertainty alone should not be a barrier to recovery. The Claimants’ submissions here are unclear, however, it is noted by the Republic that there exists an important distinction between situations where the quantum of loss is uncertain and where the existence of loss is uncertain, and the Republic reserves its right to make further submission on this point upon further clarification

47 Valuation Date

- 47.1 The Claimants assert in SoC 404 to 409 that the appropriate valuation date for their assets is 14 October 2008. This they say is the starting point for calculating the compensation due to them as a result of the alleged expropriation of their investments.
- 47.2 The Republic does not admit that any expropriation occurred and the following discussion of the Claimants’ assertion that the valuation date for assessment of quantum is strictly without prejudice to the Republic’s position in that regard.
- 47.3 The Republic says that should it be required the appropriate valuation date is 21 July 2010, being the date of termination of the KPM and TNG’s Subsoil Contracts.
- 47.4 The Republic denies that the appropriate valuation date is 14 October 2008, for the reasons given below.
- 47.5 The Claimants say that they are entitled to compensation in respect of the alleged affect on the value their Investments caused by certain alleged events of indirect expropriation
- 47.6 The Claimants allege that a wide variety of events constitute indirect expropriation (none of which allegations are admitted), occurring from 14 November 2008 onward. They also assert that the starting point for the assessment of compensation should be the value of the relevant Investment on:

⁴¹⁴ Asian Agricultural Products. Ltd. (AAPL) v. Democratic Socialist Republic of Sri Lanka, Award, 27 June 1990, ICSID Case No. ARB/87/3, paragraph 106 (**Exhibit C-225**).

⁴¹⁵ Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt, ICSID Case No. ARB/84/3, Award (20 May 1992), paragraph 188 (**Exhibit R-191**).

“the date when the indirect expropriation identifiably started, after which the market value of the Claimants investments inexorably deteriorated as a consequence of the State’s harassment campaign” (SoC 405).

47.7 The Claimants assert that date is 14 October 2008, when President Nazarbayev issue his Order to investigate KPM and TNG. However it clear there can have been no effect on the value of the Claimants investments as of 14 October 2008 or for some considerable time thereafter as follows.

47.8 In relation to President Nazarbayev’s Order of 14 October 2008, it is denied that the Order could have affected the value of KPM or TNG or their assets in any manner. Indeed it is not apparent that either company was even aware of the Order until some time later.

47.9 In relation to audits and inspections and searches by the Financial Police and various State bodies in 2008, 2009 and 2010,:

(a) it is denied that the mere act of carrying out an audit inspection or search affected the value of those companies or their assets in any manner.

(b) Whilst the Claimants complain that members of staff had to spend time responding to questions,

(i) the extent of the Republic’s audit rights were plain from the Subsoil Contracts and legislation (paragraph 20 - 20.22); and

(ii) KPM and TNG were not audited any more than other comparable companies (paragraph 20.23 to paragraph 20.33).

Therefore, any impact on the day to day running of the companies results from the Claimants failure adequately to resource KPM and TNG.

(c) To the extent that any of the staff of KPM or TNG found any of the audits distressing (which is not admitted) it is denied that this affected the value of the companies or their assets.

47.10 In relation to corporate back taxes, export duties, rent tax and transfer price taxes, it is denied that the imposition of such taxes affected the value of KPM or TNG or their assets in any manner. In particular it is noted that:

(a) Neither KPM nor TNG paid the corporate back taxes. Following the legal challenges in respect of these taxes, judgement in favour of the Republic was not given until 25 December 2009, following which KPM and TNG appealed on 6 January 2010.

- (b) Only KPM paid the first phase of export duty charges referred to (SoC 163). Only \$700,000 was paid and this was then refunded following withdrawal of the relevant charges. KPM maintained a challenge against those export duties until 23 December 2008 (SoC 165). Neither KPM nor TNG paid the second phase of export duties.
- (c) Neither KPM nor TNG paid the transfer price taxes (SoC 172 to 174).

47.11 In relation to the arrest of Mr Cornegruta and the trial of KPM it is denied that either event affected the value of either KPM or TNG in any way. In particular:

- (a) TNG was not affected by these actions.
- (b) In relation to KPM there were several other senior members of KPM and TNG (which shared KPM's offices) which were able to continue running the company in Mr Cornegruta's absence.
- (c) The mere prosecution and trial of a company does not affect its value. The first instance judgment in the case was not delivered until 18 September 2009 (SoC 118), it was then appealed. The judgment in the appeal was not delivered until 12 November 2009 (SoC 120).

47.12 It is denied that the imprisonment of Mr Cornegruta affected the value of either KPM or TNG or any of their assets in any manner. Mr Cornegruta is not an asset and there were other senior managers available to continue the operation of KPM. Mr Cornegruta was not detained until 25 April 2009.

47.13 In conclusion therefore it is apparent that even if the Arbitral Tribunal finds that there was indirect expropriation (which is not admitted) it is clear that 14 October 2008 is not the appropriate valuation date.

48 Overall methodology

48.1 The Claimants' experts have utilized a number of different methodologies as a foundation for their valuations. For the Borankol and Tolkyln fields, the DCF method has been employed. For the LPG plant and the 302 properties, the Claimants have set forward a "prospective" valuation, and for the LPG Plant, in the alternative, the book value of the plant as a proxy for fair market value has been presented.

48.2 The Republic's criticism of these methods of valuation is set out in detail in relation to each asset presented for analysis by the Claimants. However, the following observations are noted as high level criticisms of the Claimants' approach on methodology.

49 Assumptions inflating valuations for Borankol and Tolkyn

49.1 In relation to the Borankol and Tolkyn fields the Claimants adopt common assumptions for the DCF calculation they carry out. The Republic takes particular issue with the assumptions relating to price calculations which, it asserts, wrongly inflated the outcome of the valuation in relation to both the Borankol and Tolkyn fields.

Crude oil and gas condensate calculation

49.2 In respect of crude oil, as the Claimants set out in paragraph 412 of the Statement of Claim, the Claimants chose a Brent crude price based on ICE Futures prices assuming growth in 2008 and 2009. In fact, using Energy Information Administration (**EIA**) average Brent price, there was a downward trend in Brent crude oil price ignored by the Claimants.⁴¹⁶

49.3 Therefore, in forecasting the selling price of Brent crude oil FTI made an assumption that the prices will grow at the rate of 10% in 2009 and 7% in 2010, with a subsequent slowdown in growth and stabilisation in 2016 at 92.64 USD/barrel. These projections do not match the market expectations, when oil prices fell and were predicted to fall further. The condition of the oil and gas industry in 2008 was unstable, which is predominantly due to the global financial crisis. The oil price fell sharply in the second half of the year, while oil price forecasts were pessimistic with the expectation that they would fall until 2016.

49.4 FTI refers to the Bloomberg agency (ICE Futures for European Brent) in its 10% oil price growth predictions for 2009. A different proportion in established when analyzing the monthly closing oil prices (ICE Futures for European Brent) in the Bloomberg system for the period between 2008 and 2010 together with the EIA long range data at 2008.

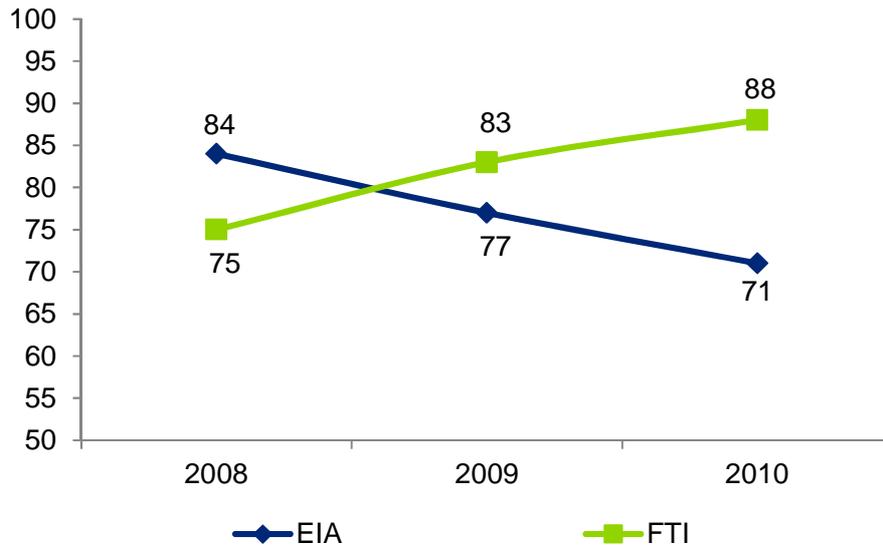
49.5 Such a projection shows an expected general fall in oil prices in 2009.

49.6 The difference between the two projections is presented in graphical form by Deloitte at paragraph 13.3 of its report:

Figure 5.1

Oil prices in 2008–2010, USD/bbl

⁴¹⁶ Deloitte Report, paragraph 13.3



Source: FTI, EIA

49.7 As to price adopted for Gas Condensate price this is based on the Brent Crude Oil Futures Curve and applied the average annual USD prices per barrel to Tolkyng gas production (see paragraph 413 of the Statement of Claim). To the extent that there was an exaggeration in the crude oil price due to the fact that ICE Futures prices was applied (as opposed to EIA average Brent price), the price for Gas Condensate is therefore accordingly exaggerated in the Claimants' valuation.

Natural Gas Price

49.8 At paragraph 414 of the Statement of Case, the Claimants have relied on the tripartite agreement negotiated in 2008 with Kazazot to export natural gas to Moldova to establish a price for natural gas. This agreement, the Claimants allege, provided (1) certain sales volumes of gas at "near market prices by the international market price after two years, and (2) export of defined volumes of gas at international market prices through KazTransGas. The chronology in relation to this agreement is detailed clearly in this Statement of Defence at paragraph 15.3 to 15.8.

49.9 As the Claimants' acknowledge, this agreement was never signed merely negotiated.

- (a) It is impossible for this to evidence any pre-agreed volumes or pricing in relation to the export of natural gas.
- (b) This is all the more the case given that (contrary to the assertion in paragraph 414), the failure to agree the tripartite agreement had nothing to do with the Republic's alleged interference but, rather related to the global economic conditions present at the time (**R - 213**).

- (c) In any event, this agreement related to the production of Kazakh fertilizer and therefore any effect that this had on the availability of a market for natural gas would have been (if it had been signed) merely coincidental.

49.10 As the Claimants state, at footnote 617 of the Statement of Claim, certain amounts of natural gas are also supplied by Borankol.⁴¹⁷ Therefore, in any event, this agreement would only be applicable for any gas sold for TNG (the party to the draft agreement) from the Tolkyn field. To the extent that the Claimants' seek to rely on this agreement as a basis for calculating the sale of any gas from the Borankol plant, this is inappropriate.

49.11 In any event even if there had been an agreement for international sale of gas (produced either by TNG or KPM), the price available would be much lower than anticipated by the Claimants for the set out below.

49.12 The Claimants have assumed that the selling price for natural gas was to remain flat through the period and amount to USD 180/000m³.⁴¹⁸

49.13 Further, the Claimants have based their price on the export of oil through KazRosGas which sells only Karachagnak gas at the price of 180 USD/thousand m³. There are a number of issues with this approach:

- (a) KazRosGas LLP was created in 2001, in accordance with an agreement⁴¹⁹ between the governments of Kazakhstan and Russia to work together in the gas industry, and was designated as the single operator to buy, sell and market Kazakhstan's export gas. In 2008, KazRosGas LLP sold only Karachaganak gas at 180 USD/thousand m³,⁴²⁰ which is the KazRosGas LLP selling price.
- (b) Accordingly, the domestic selling prices were regulated by the state and were significantly lower than export price due to the lack of any direct entry to international markets (only via OJSC Gazprom). As such, GasTradeInternational LLP exported gas produced by Tengizchevroil LLP at 70 USD/thousand m³

Gas production and export in Kazakhstan for 2005-2010

billion m ³	2005	2006	2007	2008	2009	2010
Gas production in Kazakhstan	23.0	24.0	27.0	30.0	33.0	34.0

⁴¹⁷ GCA report, paragraph 9.

⁴¹⁸ Deloitte, paragraph 13.6.

⁴¹⁹ Government resolution № 1521 dated 26 November 2001

⁴²⁰ *Kazakhstan Gas*, S M Yenikyeev, Oxford Institute, November 2008

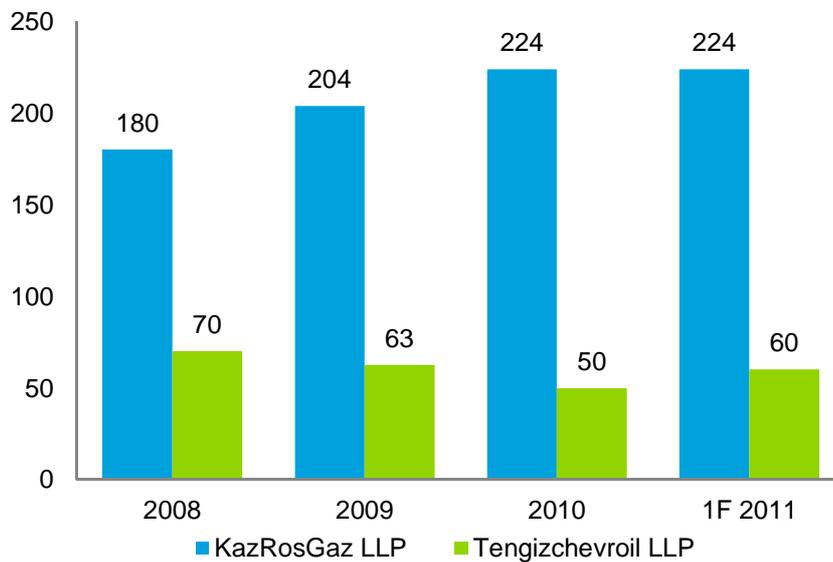
Gas production and export in Kazakhstan for 2005-2010

billions m ³	2005	2006	2007	2008	2009	2010
Gas export, including	7.6	7.7	4.5	5.7	7.0	9.0
KazRosGas LLP (Karachaganak gas)	5.3	5.4	1.9	2.3	3.5	2.9
Tengizchevroil LLP (via GasTradeInternational LLP)	1.5	1.4	2.3	1.9	3.5	4.9
Tolkynneftegas LLP (via JSC KazTransGas)	0.8	0.9	0.3	1.5	0.0	0.0
JSC KazTransGas						1.2

Source: MOG data

49.14 TNG sold gas for export through JSC KazTransGas. Therefore selling price for gas at the Claimants Valuation Date was 53 USD/thousand m³.

Comparative changes to Tengizchevroil LLP and KazRosGas LLP selling prices, USD/thousand m³



Source: JSC KazTransGas data

49.15 Thus, even if it can be demonstrated that a viable international market existed (which is denied) it would be more correct to have used the Tengizchevroil LLP and JSC KazTransOil export price of 50-70 USD. The use of this price in the Claimant’s valuation would have resulted in a lower valuation of the Tolkyn field than has been provided.

Capex

- 49.16 In relation to future capital expenditures, as described in paragraph 415, it is noted that the Claimants have failed to factor in facilities CAPEX and the timing of revenue streams is unreasonable since production is shown to commence prior to completion facilities.⁴²¹

Opex

- 49.17 The ratio of cost to BOE in FTI calculations averaged USD/BOE 14.2, which is 50-90% lower than the figure above. The Expert's use of low operating costs resulted in the Companies overstating their projected operating profit.

Depreciation

- 49.18 The Claimants' expert has consistently applied the build-up approach and Capital Asset Pricing Model to derive the discount rate with an exception of using additional discount of 30% to the country risk premium. This discount leads to decrease of 2.4% in nominal cost of equity. To justify the discount the FTI Report relies on the difference in risk characteristics of the Subject Assets and the country risk premium for Kazakhstan. The sources of information and description of procedures performed are not provided in the FTI Report.
- 49.19 The Republic asserts that the approaches applied to derive the discount rate are consistent and widely used to derive the discount rate for investments in different jurisdictions without further adjustments.

50 Tolkyn field

- 50.1 The Claimants have applied the DCF method in valuing the Tolkyn field as at October 2008 which results in the valuation pre-interest of USD 561 million. This is the largest claim next to the claim in respect of the 302 properties.
- 50.2 The Claimants' approach has resulted in an inflated assessment of the market value of the Tolkyn gas field. Even using the Claimants' valuation date, the value should have been lower. In any event, the valuation date is incorrect, and this further reduces the value properly conducted valuation using the correct valuation date. The Republic's position is as follows:
- (a) Whilst the method of valuation chosen by the Claimants is not challenged by the Republic, there are a number of criticisms and flaw in the assumptions taken by the Claimants. This has inflated the valuation put forward by the Claimants on its own valuation date.

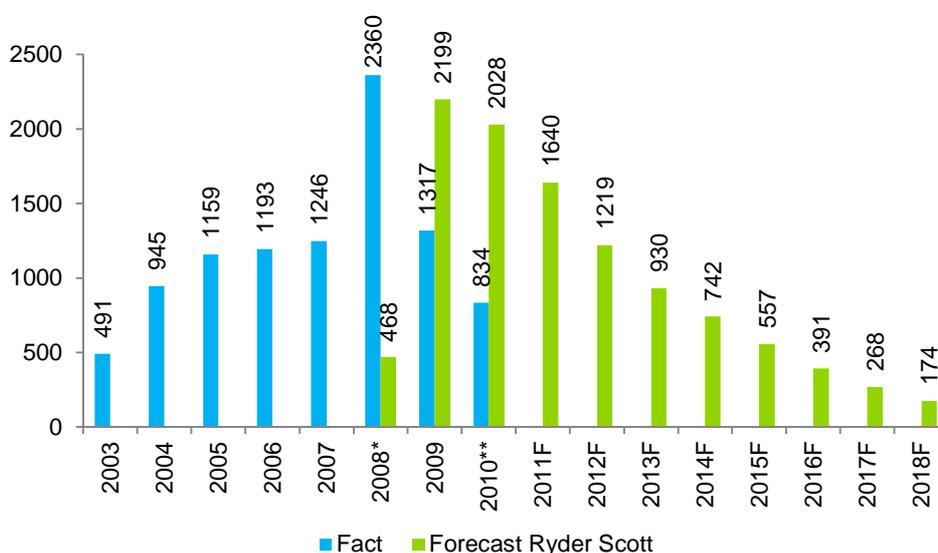
⁴²¹ GCA report, Appendix IV.

- (b) In any event, and for the reasons set out above, the valuation date is incorrect. It is noted that the valuation date of 14 October 2008 coincides with the high point in the production of the field as at that point.
- (c) Had a later date been taken the projected production would have been lower. Notably, the effect of flooding in the wells would have been evident and would have resulted in a lower valuation.
- (d) Accordingly, if the correct valuation date is taken, the valuation of the field, using the same method of valuation and largely the same assumptions, yields a far lower valuation.
- (e) If it is established that compensation is payable, the correct valuation of the field is USD116 million.

Beneficial Valuation Date

50.3 Production levels of the Tolkyn field as at the valuation date in 2008 were 2.4 million m³ of gas (a significant increase from 1.2 mln m³ in 2007)⁴²² as shown by the following data taken from Ryder Scott's own report.

Changes to production growth at the Tolkyn field, million m³



Source: Branch data⁴²³, Ryder

Note: *the Ryder gas production forecast was for the period between the Claimant's Valuation Date and 31 December 2008; **actual gas production is for the 7 months of 2010

⁴²² GCA report section 6.1.

⁴²³ According to a government resolution, the Valuation objects were transferred to the trustee management of JSC NC KazMunaiGas. The branch JSC Offshore Oil Company KazMunaiTengiz (the "Branch") was created to ensure continuous production in Aktau, and from 22 July 2010 carried out operations at the Valuation objects.

- 50.4 This peak in production is reflected also reflected in GCA's report at paragraph 29.
- 50.5 At the Claimant's valuation date, there were issues with the cut in the wells at Tol kyn. The following is noted:
- (a) Water production increased significantly shortly after gas production was increased in 2007 and 2009, and water production declined as gas production reduced to 2006 production rates.⁴²⁴
 - (b) Water production increased quickly after gas production rates were increased in mid 2007. This may indicate rapid water migration through fractures in the reservoir to the wells. This feature is typically observed in many carbonate reservoirs.
 - (c) While a revision to the field development plan in 2009 sought to reduce water breakthrough, water production was significantly increased again in 2010 and, conversely well rates have reduced.⁴²⁵
- 50.6 The presence of water is shown against production in GCA's report at paragraph 29.

Price of Gas

- 50.7 The Republic has set out above its criticisms as to the manner in which the Claimants have calculated the gas and gas condensate price for the purpose of their calculations. In summary, in relation to the gas condensate price, this relies on an inappropriate standard for assessing the price. In relation to the gas price, this entails seeking to rely on an unsigned agreement to demonstrate that there was an international market for gas. While both of these affect that valuation for the Tol kyn, the effect on the valuation of the calculation for gas is particularly profound for the following reasons:
- (a) TNG had no history of historical sales in the international market. As set out in paragraph 57 of the Statement of Claim, sales of TNG case were historically made through three domestic users.
 - (b) It was decided by the Kazakh competition authorities that TNG held a dominant position (C-64) and accordingly its ability to raise its gas prices was controlled and limited and, the Claimants assert, was significantly depressed against international prices.
- 50.8 The Claimants' ability to use an international gas price for any period is dependent on being able to demonstrate a market for international sales and / or historical international sales.

⁴²⁴ GCA Report, paras 33 to 35.

⁴²⁵ GCA Report, paragraph 210.

- 50.9 The Claimants' attempt to rely on an unsigned agreement relating coincidentally to the sale of gas internationally is an unsuccessful attempt to demonstrate that an international price should be utilized and had the effect of inflating the valuation.⁴²⁶
- 50.10 Accordingly, the specific valuation date chosen was significant in relation to the Tolwyn field valuation and had the effect of maximizing the amount of production forecast using the DCF method. Allowing the claimants to minimize the effect of the water flooding in the wells and allowing the Claimants to rely on an unsigned agreement that to utilise international sales prices in their valuation.
- Correct Valuation*
- 50.11 Taking the above into account, the Republic's expert has presented a valuation for the Tolwyn field based on the valuation date of 21 July 2010. It has run this on the DCF method and based this valuation on the assumptions set out in its report at Section 7.
- 50.12 Accordingly, should the Arbitral Tribunal find grounds on which to compensate the Claimants for expropriation, the correct valuation is USD 120 million.

51 Borankol field

- 51.1 It is admitted that the DCF is an appropriate method for the valuation of the Borankol field as asserted in paragraph 411 of the Statement of Claim.
- 51.2 The Republic has the following observations regarding the valuation used by the Claimants.
- 51.3 Firstly, the comments regarding the price assumption in relation to both oil and gas set out above apply here. The Claimants' choice of oil price figures affected the long term projections of oil price and, therefore, unduly inflated the valuation of the Borankol field.⁴²⁷
- 51.4 Secondly, KPM's depreciation charges projected by the Claimants' expert are significantly lower than actual charges for 2007-2008. KPM's actual depreciation in 2007-2008 averaged USD 32,041 thousand. However, in 2009 the Claimants forecast a sharp fall in KPM's depreciation charges to USD 728 thousand. In 2009, according to financial statements, the depreciation of KPM's fixed assets amounted to USD 20,278 thousand.
- 51.5 Lastly, it is noted that the Borankol production profile on which the Claimants' expert based the valuation, shows significant unexplained production increases in 2015 and 2016.⁴²⁸ The effect of this on the valuation is not admitted and the Claimants are put to proof.

⁴²⁶ Deloitte, para 13.6.

⁴²⁷ Deloitte, paragraph 13.3.

Correct Valuation

- 51.6 Taking the above into account, the Republic's expert has run a valuation for the Borankol field based on the valuation date of 21 July 2010. It has run this on the DCF method and based this valuation on the assumptions set out in its report at Section 6.
- 51.7 Accordingly, should the Arbitral Tribunal find in relation to the Borankol field there grounds to compensate the Claimants for expropriation, the correct valuation is USD 17 million.

52 Contract 302 Properties

- 52.1 The Claimants address the compensation to which they claim to be entitled in respect of the Contract 302 Properties at paragraphs 421 to 452. At \$1.7bn (plus interest) The Claimants claim in respect of the Contract 302 Properties comprises over 60% of the total value of their claim.

- 52.2 As GCA comment:

"Block 302 was an exploration block covering some 705 km². It is located to the south-west of the Tolkyn Gas Field in western Kazakhstan. Like the Tolkyn Field the area covered by Block 302 is subject to intermittent flooding by the waters of the Caspian Sea. This has caused operational problems in the past, leading to a period of Force Majeure being declared following a significant flood.

TNG has drilled two exploration wells on the block (East Munaibay-1 and Bahyt-1), both discovering hydrocarbon bearing reservoir intervals. However, to date the commercial potential of these discoveries has not been confirmed by any appraisal drilling. In addition to these discoveries a number of undrilled prospects and leads have been identified."

- 52.3 As such much of the claimed "potential" of the Contract 302 Properties remains unexplored. Nevertheless the Claimants seek to attribute some value to all areas of the Contract 302 Properties, whether or not explored, which they admit *"presents a greater valuation challenge"* SoC 421.

The Claimants' method of valuation of the Contract 302 Properties

- 52.4 The Claimants present a "Prospective Valuation" of the Contract 302 Properties. The precise nature of a Prospective Valuation is not immediately clear from the Claimants Statement of Claim. In SoC 422 to 427 they discuss the basis on which a claim for loss of opportunity may be made. However in the course of SoC 428 to 429 they appear to segue into a claim for loss of profits.

⁴²⁸ GCA Report, paragraph 46.

52.5 However, ultimately it is clear from SoC 421 that, whatever gloss the Claimants attempt to put on their claim in respect of the Contract 302 Properties, they are essentially making a claim for “profits the Claimants could have earned if allowed to process the potential gas volumes from the Contract 302 Properties”. There is no apparent attempt to discount forecast future profits as would be required for a claim for lost opportunity. Accordingly the Claimants entitlement to the sums claimed should be judged by reference to the requirements for making a claim for lost profits and in particular the requirements as to certainty as to which the Republic repeats paragraphs 46.19 to 46.26 above.

52.6 It is also instructive to look at the limitations on the ability to claim lost profits cited by the Claimants themselves:

- (a) In *Gemplus and Talsud v Mexico* (C-309) the tribunal recognised that an assessment of the probability of future events (such as would lead to generation of a profit) as follows:

“It is not always possible for a claimant to prove that a future event could or could not happen with certainty; and a tribunal can only evaluate the chances of such a future event happening.”

- (b) In *Lemire v Ukraine* (C-61)

“The Tribunal agrees it is a commonly accepted standard for awarding forward looking compensation that damages must not be speculative or uncertain, but proved with reasonable certainty...The Claimant only needs to provide a basis upon which the Tribunal can, with reasonable confidence, estimate the extent of their loss.”

52.7 Despite the Claimants’ suggestions to the contrary, certainty is a required factor in awarding compensation for loss of profits. Further, it should be noted that, whilst the Claimants place heavy reliance on the apparently lenient reasoning of the Tribunal in *Gemplus*, this is misplaced since the tribunal in that case proceeded to analyse the claims in terms of lost opportunity:

“Accordingly, with this valuation method, the Tribunal next addresses, on the facts of this case, the Concessionaire’s chances of future profits and seeks to quantify the resulting compensation for the Claimants’ claims derived, indirectly, from those lost profits in order to value the Claimants’ shares as at the relevant valuation date” (C-309 page 65)

52.8 It is therefore amply clear that in order to make good a claim for lost profits, the Claimants must prove those profits would have arisen with reasonable certainty.

Uncertainty of resources and profits in the Contract 302 Properties

52.9 The uncertainty as to the potential of the Contract 302 Properties represents a fundamental difficulty for the Claimants’ valuation. As can be seen from tables AIII.1 and AIII.2 (GCA Appendix III) the vast majority of the potential resources fall into the category of “Prospective Resources” under the PRMS system of classification (see table below), that is the category least likely to exist or be capable of commercial exploitation.

PRMS classification of reserves and resources

Total oil/gas originally in place	Discovered	Commercial	Production Reserves			Project sub-stages	Increasing probability of commercial production ↑
			<div style="display: flex; justify-content: space-around;"> <div style="background-color: #90EE90; padding: 5px; text-align: center;">1P Proved</div> <div style="background-color: #90EE90; padding: 5px; text-align: center;">2P Probable</div> <div style="background-color: #90EE90; padding: 5px; text-align: center;">3P Possible</div> </div>			Production	
						Development is approved	
	Contingent commercial	Contingent resources			Awaits development		
		<div style="display: flex; justify-content: space-around;"> <div style="background-color: #D3D3D3; padding: 5px; text-align: center;">1C Lowest estimate</div> <div style="background-color: #D3D3D3; padding: 5px; text-align: center;">2C Best estimate</div> <div style="background-color: #D3D3D3; padding: 5px; text-align: center;">3C Highest estimate</div> </div>			No clarity on development or delayed		
					Development is non-commercial		
		Unrecoverable					
	Undiscovered	Prospective resources			Exploration block		
		<div style="display: flex; justify-content: space-around;"> <div style="background-color: #ADD8E6; padding: 5px; text-align: center;">Low estimate</div> <div style="background-color: #ADD8E6; padding: 5px; text-align: center;">Best estimate</div> <div style="background-color: #ADD8E6; padding: 5px; text-align: center;">High estimate</div> </div>			Identified prospect		
					Potential oil/gas bearing area		
Unrecoverable							
← Probability range →							

Source: PRMS

52.10 Both Ryder Scott and GCA have assessed the Geological Chance of Success (GCoS) for each of the prospects in the Contract 302 Block. As GCA explain GCoS is:

“GCoS is the chance that if drilled the well will encounter hydrocarbons in the reservoir being evaluated within the estimated range of volumes.” (GCA para 69)

52.11 It should be noted that GCoS does not assess the prospect that once discovered the hydrocarbons are capable of commercial exploitation. That is a separate level of analysis and risk.

52.12 The principal potential value in the Contract 302 Properties according to the Claimants, lies in it's the potential gas resources. Of these 96% of the estimated volume are Prospective Resources (RS Exhibit 12). Of those Prospective Resources, 93% are represented by the so-called Inter-Oil or Carboniferous Reef (RS Exhibit 12).

52.13 Ryder Scott have assessed the GCoS of the Inter-Oil Reef as 0.05 - that is a 95% chance that the claimed resource does not exists (RS p6). GCA assess the GCoS as 0.04 - that is a 96% chance that the claimed resource does not exist.

- 52.14 For the purpose of a claim for lost profits however it is also necessary to take into account the prospects of exploiting any existing resource in an economic fashion, the Economic Chance of Success (**ECoS**). As GCA describe addresses the “*economic, market, legal, environmental, and project approval risks.*” (GCA para 79).
- 52.15 ECoS is applied to GCoS to reflect the further risks involved in bringing a resource to market. In relation to the Inter-Oil Reef GCA assessed the ECoS to be 50% (GCA Appendix III). So, while there is only a 4 to 5% chance that the claimed resource actually exists, there is a further 50% risk that, even if it does exist, it will not possible to exploit the resource.
- 52.16 Put another way there is a 98% chance that no profit will ever result from the Inter-Oil Reef even if one assumes that there are no other external factors which would prevent a profit from being realised.
- 52.17 If this process is applied to the other areas of the Contract 302 Properties it is apparent that:
- (a) Only two areas have more than a 50% chance of making any profit at all.
 - (b) Further, those two areas represent only a quarter of the Claimants overall claim.
 - (c) The areas making up 73% of the Claimants’ claim by value have no better than a 16% chance of making a profit.

Contract 302 Area	Claimants' value (FTI)	GCoS (GCA)	ECoS (GCA)	Resultant chance of profit*
Contingent Reserves				
Tabyl Main	\$44.384m	100	75%	75%
Munaibay Main	\$388.105m	100	50-75%	50-75%
Prospective Reserves				
Tabyl West	\$24.587m	72%	0%	0%
Munaibay North	\$41.958m	32%	50%	16%
Inter-Oil Reef	\$1,202.974m	4%	50%	2%
Bahyt	\$57.689m	29%	50%	14.5%

*assuming the Claimants economic forecasts and analysis are correct

The Claimants’ objectionable treatment of uncertainty

- 52.18 Applying this to the above analysis of the legal standard of certainty required to make a claim for loss of profits it is plain that the vast bulk of the profits claimed by the Claimants, which relate to

the gas produced from the Inter-Oil Reef, are extremely unlikely ever to be achieved and far too uncertain to be permissible as a claim for loss of profits.

52.19 However, the Claimants' claim makes no allowance for this uncertainty. On the contrary as FTI state in their report:

"[The calculation of Prospective Value for the Contract 302 Properties] assumes that all the Contract 302 Property resources are process reserves and that the "2C estimate" and "Best Estimate" production projections are fully achieved"

52.20 Considering that the Claimants own expert Ryder Scott agrees that none of the Contract 302 Property resources are Proven Reserves, within the above PRMS classification scale, and that 75% by value are Prospective Resources (the opposite of Proven Reserves) this is a wildly unrealistic assumption.

52.21 The Claimants' apparent justification for this stance is summed up in SoC 438:

"Given the totality of the circumstances surrounding the State's expropriation and severe mistreatment of Claimants' investments...Claimants believe that these various risk factors should not be applied at all in assessing the appropriate damages to be awarded for the 302 Properties. In other words it is the State, and not the Claimants, who should bear those risks as a consequence of the State's deplorable conduct in this case."

52.22 This is objectionable for several reasons:

(a) As noted above the Claimants blend references to decisions concerning loss of opportunity, with a claim that is unashamedly for loss of profits. This is conceptually flawed. In a claim for loss of opportunity the *qui pro quo* of the leniency in terms of certainty of profits is that expectations as to the extent to which forecast profits are recoverable are diluted.

In effect they are asking the Arbitral Tribunal to invoke the more lenient tests of certainty appropriate for a claim for loss of opportunity whilst supporting the Claimants entitlement to recover every cent of profit that would result should every estimate prove absolutely true. Whilst the Republic does not assert that the Claimants should prove their claim for lost profits with absolute certainty, there is simply no support for this either as a matter of authority or as a matter of logic for the extreme position that the Claimants adopt.

(b) The degree of uncertainty as to the profits claimed is unprecedented, even for a claim for loss of opportunity. Not only is the likelihood of commercial activity occurring uncertain (ECoS), but the very existence of the subject of that activity uncertain also (GCoS).

The acceptable bounds of uncertainty in a claim for loss of profits are illustrated by the tribunal in *Sapphire International Petroleum Ltd v National Iranian Oil Company*, to which the Claimants refer. There the tribunal were considering the loss of opportunity arising from a oil and gas prospect in relation to which:

“it is possible to affirm that there is a very strong chance, but not a certainty, that deposits of commercially workable oil exist in the concession area” (C-308 at 188)

In the present case, virtually the opposite applies. In relation the Inter-Oil Reef which represents 68% of the Claimants’ claim by value, GCA is not only assigning an ECoS value of 0.5 they also state:

“In conclusion, there is insufficient data (and hence, evidence) for the presence of a prospect. The Inter-Oil Reef would therefore be more appropriately described as a “concept” or “play” as there s little or no data to support its presence”

It is this analysis which leads GCA to assign the Inter-Oil Reef a GCoS of 0.04, an assessment that is almost completely mirrored by the Claimants’ own expert.

- (c) The Claimants are effectively asking the Tribunal to punish the Republic for alleged wrongs by awarding very considerably enhanced damages. There is absolutely no authority for an award of what amount to punitive or exemplary damages in these circumstances.

Further the Tribunal is asked to reward the Claimants (for reasons that are unclear) by relieving them of all technical and commercial uncertainties that would ordinarily afflict in ordinary commercial life. This is a further example of the fact that the Claimants’ objective is to obtain money rather than redress and, in this case, quite literally profiteering.

Conclusion as to the Claimants’ entitlement to lost profits in respect of the Contract 302 Properties

- 52.23 There is no doubt from the calculation of the “Prospective Value” of the Contract 302 Properties that the Claimants assert a straightforward claim for lost profits with no account taken for any form of risk that the forecast profits might not emerge.
- 52.24 It is equally clear that the Claimants adopt a wholly unsustainable argument as to manner in which the Arbitral Tribunal should allocate the risk associated with the claimed profits. The legal reality is that to succeed, the Claimants must prove that the profits claimed were reasonably certain to materialise. The factual reality is that the Claimants fail completely to do this and their far fetched argument as to the appropriate allocation of risk is tantamount to an admission of this.

52.25 The Claimants' claim for the prospective value of the 302 Properties should be rejected in its entirety

Quantum of the Claimants Prospective Value of the 302 Properties

52.26 Quite aside from the legal flaws in the Claimants claim for lost profits, there are substantial technical flaws in the assessment of alleged lost profits identified by GCA in Appendix IV of their report. These suggest that the amount of profit is likely to be substantially overstated and/or unreliable. Flaws include the following:

- (a) Low, Best and High production profiles for the Block 302 leads and prospects are provided by FTI in Exhibit L. There is no basis provided for these profiles. In all cases it is unlikely that production start could be achieved in the timeframe assumed.
- (b) InterOil Reef described as an analogue to Tengiz, but no consideration of H₂S, and its impact on development timing and costs is made. No consideration is given to sulphur disposal, which is a major issue for operations at Tengiz.
- (c) Well costs for the deeper wells required for block 302, InterOil Reef are understated compared with cost reported for analogue fields at similar depths.
- (d) For Block 302 prospects, revenue streams are forecast to commence before adequate costs are expended – essentially the facilities and pipeline cannot be completed in the timescale used.
- (e) Gas pricing: A very steep increase in realised prices is being used in the cash flows, with significant growth upon the historical prices achieved for Tolkyin sales. There is currently only a limited gas market, with small scale domestic sales, and potentially larger but still constrained export sales. The only export market is Russia, which dictates the prices it will pay. Gas export volumes are constrained by Russian demand, and increased export volumes from Block 302 could only be achieved at the expense of other Kazakh production / exports. Only very low prices are currently achieved by Tengiz and Karachaganak for exports. There are plans in place to significantly increase Karachaganak export volumes to Orenburg in Russia(at prices reported to be below U.S.\$40 Mcm), which could absorb any potential increase in demand. The Kashagan project is being developed with limited gas sales due to demand, pricing and sulphur disposal issues.
- (f) Ramp-up profiles for gas and liquids for the InterOil Reef lead are unlikely to be achievable. Exhibit L shows production start in 2010. It would not be possible to even appraise the prospect's potential in this time frame. The development of such a complex prospect could reasonably be expected to take in the order of 7 to 10 years from exploration to production start.

- (g) Assumed well costs are provided but with no basis or breakdown. The cost estimates for the “deep” wells, in the order of 6,000 metres, are low compared to reported drilling costs on Karachaganak and Tengiz, which are assumed to be analogue reservoirs. GCA has prepared independent cost estimates for drilling on each lead, prospect and discovery.
- (h) To drill any well to a depth of over 5,000 metres is technically challenging and requires best in class, high specification drilling rigs. The planned wells for the InterOil Reef lead are far in excess of this depth.
- (i) If the InterOil Reef structure is proven to exist, it is likely to be analogous to the Tengiz structure. The Tengiz structure lies below a thick layer of salt, is overpressured, and has a high H₂S content. These characteristics greatly increase the complexity and cost of drilling wells, and the cost of gathering and processing facilities. The Kashagan development, in the Caspian Sea has similar characteristics.
- (j) Given the absolute uncertainty in reservoir characteristics, the estimated well counts (Exhibit L) are understated. In the Best Estimate case, it would be reasonable to assume that almost double the number of wells indicated would be required.
- (k) Costs for wells at Tengiz and Karachaganak wells are reported to be between U.S.\$25 MM and U.S.\$30 MM each. GCA has prepared independent well cost estimates for the InterOil Reef, based on a typical well depth of 6000 metres, and arrived at an average cost of U.S.\$25 MM per well. Costs for an 8000 metre well, should this be required, would be in the order of U.S.\$30 MM.
- (l) Development of the InterOil Reef would be a much more complex and challenging project due to its likely high pressure and the high H₂S content of the gas. The development would require use of industry leading expertise and technology as deployed on the Tengiz and Karachaganak developments, including use of Corrosion Resistant Alloys (CRA) for well tubing, flowlines and processing equipment, state of the art H₂S extraction and sulphur recovery facilities, installation of complex safety systems and major investment in infrastructure, such as railroads to export the sulphur. There is no evidence that this has been considered in the capital cost profiles used by FTI.
- (m) The total CAPEX in the FTI cash flow (Exhibit H) is in the order of U.S.\$1,360 MM. Although not clear, it is assumed (based on 15.11 of the report) that this CAPEX assumes success in exploration and appraisal of all of the Block 302 leads and prospects and is for development of all of these prospects. This compares to the GCA estimate of U.S.\$2,150 MM for the InterOil Reef prospect alone.

52.27 Therefore, not only do the Claimants fail to establish a legal basis for their claim for a “Prospective Valuation” of the 302 Properties it is clear that their calculation of that value is significantly overstated and cannot be relied upon by the Arbitral Tribunal in any measure.

The Republic’s valuation of the 302 Properties

52.28 It is notable, that unlike their valuations for the Tolkyn and Borankol fields and the LPG plant the Claimants present neither “fair a market value” (SoC paragraph 410) nor even a “proxy for fair market value”(SoC 419). Rather, they present what they term a “Prospective Valuation” (SoC Section VIII D 2(a)) based on “profits the Claimants would have earned if allowed to process the potential gas volumes from the Contract 302 Properties” (SoC 421).

52.29 Accordingly on the Claimants’ own case, to the effect that fair market value is the appropriate compensation for lawful expropriation, if the Arbitral Tribunal concludes that there has been no unlawful expropriation, the Claimants have not advanced an applicable assessment of the compensation they say is due in respect of the Contract 302 Properties.

52.30 The Republic has instructed Deloitte to prepare a fair market valuation of the Contract 302 Properties on its behalf using a more appropriate DCF valuation methodology.

52.31 It is important also to recognise that the true character of the investment in question is TNG’s Subsoil License and corresponding Subsoil Contract for the 302 Properties.

52.32 The second important point of principle is that, for the reasons given in paragraph 47 above, the appropriate valuation date is 21 July 2010.

Primary case valuation

52.33 Proceeding on this basis, the Republic’s primary case is that no compensation is due to the Claimants because TNG’s Subsoil Licence and Subsoil Contract for the 302 Properties expired on 30 March 2009, for the reasons set out in paragraph 14.17 to 14.35 above. Accordingly Deloitte have concluded that the market value of the 302 properties is zero, on the basis of the assumptions and methodology set out in their report (Deloitte’s Report page 19).

Secondary case valuation

52.34 The Republic recognises that the Claimants assert that the Republic wrongly refused to grant a two year extension to TNG’s Subsoil Licence (which the Republic denies). Therefore the Republic has also requested Deloitte to prepare an alternative valuation based on the hypothetical scenario in which TNG’s exploration licence was extended for two years (as contended for by the Claimants), and that a production licence is subsequently granted. Needless to say these are very generous assumptions.

- 52.35 On the basis of the assumptions and methodology set out in their report Deloitte arrived at the following value for the Contract 302 Properties:

Table 10.2	
Valuation results	
	Value, USD mln
Prospective area of Contract 302	
Munaibay (crude oil)	69
Munaibay (natural gas)	0
Munaibay North	0
Bahyt	0
Interoil Reef	0
Total	69

Source: Deloitte estimates

53 LPG Plant

- 53.1 The Claimants present two alternative valuations for the LPG plant. Their primary valuation (SoC 447 to 452) is said to be a “prospective valuation” of the LPG plant. Their secondary valuation (SoC 419 to 420) is based on the book of the plant which the Claimants say is a “proxy” for fair market value.
- 53.2 As to the design and status of the LPG plant GCA comment:

- “49. The BLPG Plant is designed to utilise gas from the Tolkyn and Borankol Fields, to use any gas produced (composition unknown) from Block 302 (Tabyi Block), and possibly gas from third part sources. It has a nominal design capacity of 7.1 MMscmd.
50. The BLPG plant is designed to take the ‘rich gas’ from the Tolkyn Field (after condensate has been removed) to produce liquid petroleum gases (butane, propane) as well as pentane and heavier fractions and ‘sales gas’.
51. Gas / Condensate from the Tolkyn field is transported to Borankol by pipeline. First stage gas processing takes place at a gas pre-treatment plant located at the Borankol Field, allowing rich gas (wet-gas) export to the CAC pipeline. Gas from the Borankol Gas processing facility is also sent to the BLPG plant by pipeline. Once the LPG plant is operational, lean (export) gas will be exported to the CAC pipeline, LPG (Propane and Butane) will be exported by rail, and the condensate /

pentane / C5+ liquids returned to Borankol and blended with the condensate recovered in the initial gas processing facility.

52. *The LPG Plant is located at the Borankol facility. This gas plant is planned to provide LPG recovery (C3 and C4) as well as heavier C5 plus fractions from the pre-treated gas stream, and fractionation of the LPG into propane and butane. Storage spheres and tanker loading facilities for propane and butane are included.*

...

60. *The estimated capital cost for the LPG plant (estimated in December, 2007) was U.S.\$320 MM (48,300 MM Tenge). This estimated cost appears to be reasonable at that date for the plant as designed.*

61. *Construction of the LPG plant is reported to have stopped in March, 2009, and the equipment mothballed. The reported progress at that time was:*

- a) *Gas Desulphurisation Plant and Fractionation Plant - 73% complete, with 95% of the equipment installed;*
- b) *Pipeline for Borankol Gas Plant to the LPG plant – 90% complete;*
- c) *LPG storage Tanks – in the order of 75% complete; and*
- d) *Power Station – 80% completed.*

62. *GCA believes that the following will be required to complete the plant:*

- a) *Contract with the design contractor to audit the plant and equipment status, and obtain all necessary design documentation, operating manuals and equipment warranties as appropriate;*
- b) *Contract with major mechanical equipment suppliers to inspect their equipment, carry out remedial work and re-certify (Jenbacher, Solar);*
- c) *Establish scope of work for completion of the works, identify equipment and materials in storage, re-order where necessary;*
- d) *Complete construction works, including piping systems, electrical and instrumentation and insulation;*
- e) *Procurement of spares and operating consumable;*

- f) *Identify operation entity, train workforce; and*
- g) *Commission and start up the plant.”* (GCA 49 to 62)

Prospective Valuation

- 53.3 The Claimants rely on the same justification for the use of a prospective valuation for the LPG plant as they do for the prospective valuation of the Contract 302 Properties (SoC 421 to 438). In that respect the Republic repeats paragraphs 52.4 and 52.5 above as to the true nature of the Claimants claim and paragraphs 46.19 to 46.26 and 52.6 to 52.7 as to the Claimants obligation to prove lost profits with reasonable certainty.
- 53.4 The Claimants have failed to prove their claim for lost profits with sufficient certainty for the following reasons:
- (a) As noted by FTI (FTI 16.1) the Claimants claim for lost profits assumes that the LPG plant received gas from the Contract 302 Properties. For the reasons given at paragraphs 52.9 to 52.17 there is considerable uncertainty as to the existence, let alone the commercial viability of the resources in the Contract 302 Properties. As such, their contribution to the production of the LPG plant is equally uncertain.
 - (b) As noted by GCA, the quality of the gas from the Contract 302 Properties is unknown (GCA 49) therefore the quantity of LPG products that can be derived from that gas and the resulting revenue cannot be predicted.
 - (c) The LPG plant is not complete and there are no contracts in place for the sale of its product. Accordingly the notion that profit will be generated at all is far from certain, let alone the amount.
 - (d) Ryder Scott appear to assume that the LPG plant may be fed by supplies of gas purchased from third parties. There are no contracts or infrastructure in place to permit that supply. Even if it is assumed that both contracts and infrastructure can be obtained, the terms of supply and the quality of the gas supplied is unknown. Therefore the cost of the gas the amount of the resulting LPG products is unknown. Further as GCA note (GCA 69) the Claimants appear not to have accounted for the cost of infrastructure required to provide third party gas feeds to the LPG plant.
- 53.5 The Claimants' assertion as to the treatment of the uncertainties over the supply of gas from the Contract 302 Properties are the same as for the prospective valuation of the Contract 302 Properties themselves (SoC 433 to 438). Accordingly, the Republic repeats paragraph 52.22 above.

- 53.6 The Claimants do not address the other uncertainties as to the profits from the LPG plant identified in paragraph 53.4 above.
- 53.7 In conclusion therefore, as with the Claimants claim for a Prospective Valuation of the Contract 302 Properties, the Claimants adopt a wholly unsustainable argument as to manner in which the Arbitral Tribunal should allocate the risk associated with the claimed profits. The legal reality is that to succeed, the Claimants must prove that the profits claimed were reasonably certain to materialise. The factual reality is that the Claimants fail completely to do this.
- 53.8 Therefore the Claimants' claim for the prospective value of the LPG Plant should be rejected in its entirety

Quantum of the Claimants' Prospective Value of the LPG plant

- 53.9 There are substantial technical flaws in the assessment of the alleged lost profit claimed by the Claimants in relation to the Prospective Value of the LPG plant.
- 53.10 First, although the Claimants say that the Prospective Value is \$344,000,000m (Soc465), FTI states that is \$333,946,000 (FTI 2.8 Table 1) - Just over \$10,000,000 less.
- 53.11 To the extent that the LPG plant relies on gas from the Contract 302 Properties, it is assumed that the Claimants rely on their own reasoning as to the production of gas from those properties. Therefore the following flaws in that reasoning identified by GCA in Appendix IV of their report are relevant:
- (a) FTI has used the unrisks volumes estimates for the purposes of the evaluation "This assumes that all the Contract 302 Properties resources are proven reserves and that the 2C estimate and Best Estimate production projections are fully achieved". This is not accepted Industry best practise in the evaluation of exploration properties, where the Geological Chance of Success (GCoS) and Economic Chance of Success (ECoS) are taken into account.
 - (b) Ramp-up profiles for gas and liquids for the InterOil Reef lead are unlikely to be achievable. Exhibit L shows production start in 2010. It would not be possible to even appraise the prospect's potential in this time frame. The development of such a complex prospect could reasonably be expected to take in the order of 7 to 10 years from exploration to production start.
 - (c) To drill any well to a depth of over 5,000 metres is technically challenging and requires best in class, high specification drilling rigs. The planned wells for the InterOil Reef lead are far in excess of this depth.

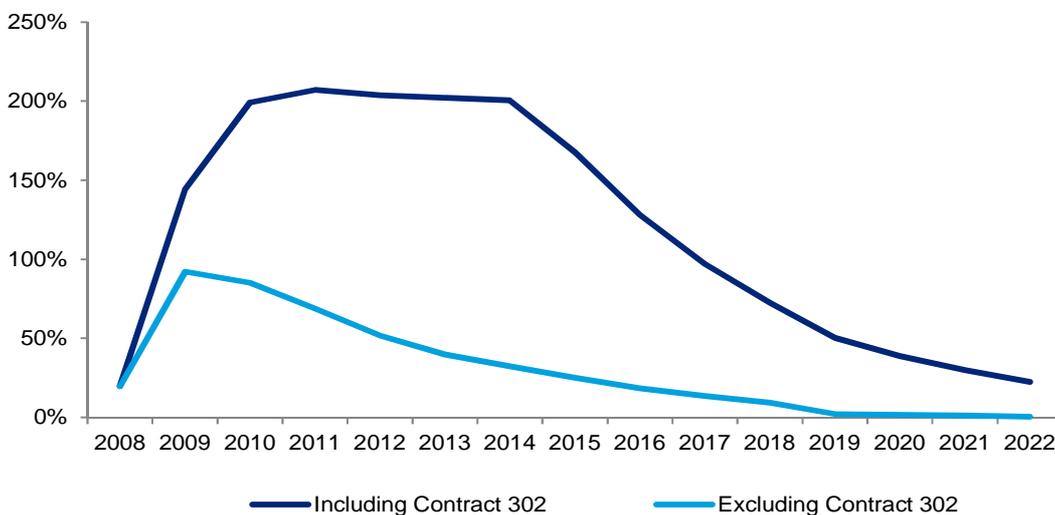
53.12 In relation to the LPG plant itself, GCA has identified the following additional flaws in the Claimants’ analysis, as set out in Appendix IV of their report:

- (a) Production is assumed to continue at plateau levels until 2018. There is no discussion regarding the source of the additional gas (beyond Tolwyn and Borankol Production), but this is assumed to be unrisksed production from Block 302.
- (b) Volumes make no allowance for minimum gas flowrate (turndown) through LPG plant (estimated to be 25% of design rate – circa 75 MMscfd, or 18,000 MMscf per year.) Below this rate, the plant will not operate.
- (c) LPG plant completion costs of U.S.\$24 MM only are allowed. This compares to the TNG estimate of U.S.\$50 MM, and a more realistic GCA estimate of U.S.\$100 MM, given the actual progress achieved.

53.13 A further issue is identified by Deloitte in their report as follows (Deloitte Para 13.8)

“In prospective value calculation of the LPG Plant FTI failed to consider the capacity limit of the LPG Plant resulted in 128–207% of capacity used in 2009–2016. Any further discussion on expansion of the plant or capital expenditures required was not provided in the FTI report.”

Figure 13.3
Capacity utilization of the LPG Plant



Source: FTI report

53.14 Clearly therefore the profits for that period will be overstated.

53.15 Therefore, not only have the Claimants failed to establish a legal basis for their claim for a “Prospective Valuation” of the LPG plant, it is apparent from the above that their calculation of that value is overstated and cannot be relied upon by the Tribunal in any measure.

The Claimants' Book Value of the LPG plant

53.16 The Claimants' secondary valuation relies upon the book value of the LPG plant, which they say is a "proxy" for fair market value (SoC 419). This is denied as follows:

- (a) For the fair market value to be equivalent to the book value of the LPG plant there would have to be a reasonably immediate prospect of generating a return on those assets through operation of the plant. Otherwise no buyer would be interested in purchasing a collection of ageing assets constituting an incomplete plant, since the assets themselves would be worth less on the open market than the price paid. This is confirmed by Deloitte as follows:

"FTI has applied the Cost Approach to arrive at the market value of the LPG Plant of USD 208.5 mln. This approach is based on the assumption that the historical costs incurred during a plant's construction would be recovered by future cash flows from gas processing. Taking into account the limited economic life of Borankol and Tolkyn fields, alternative sources of plant feedstock should have been thoroughly analysed. This analysis could probably result in evidence of the Claimants' inability to load the plant. Should a DCF analysis be applied, this finding could be treated as a source of the LPG Plant's economic obsolescence, which, in its turn, leads to lower market value of respective assets."

(Deloitte paragraph 13.8)

- (b) Accordingly book value would only be appropriate where it can be said once the plant has been completed and commissioned, at a minimum that:
- (i) a gas supply is secured;
 - (ii) a market is established for the LPG products; and
 - (iii) a market is established for the remaining dry gas.
- (c) The Claimants have failed to establish that any of these conditions are fulfilled. Indeed the Claimants' expert reports reveals:
- (i) There was no agreement in place for the assumed third party a gas supply (FTI 13.2).
 - (ii) Although there were third party gas suppliers nearby, there is no mention of the necessary infrastructure required to supply the plant (FTI 13.3).

- (iii) There was almost no prospect that the vast majority of the claimed gas resources from the Contract 302 Properties actually existed, indicated by very low GCoS figures for the resources in question (RS pages 5 and 6)
- (d) Further, in addition to the Contract 302 Properties and third party gas suppliers, the Claimants rely heavily on gas supplies from the Tolwyn field to feed the LPG plant. However, as can be seen from the diagram at paragraph 46.13 above, gas supply in the Tolwyn field has slumped significantly in early 2008 as water production in the gas wells spiked as a result of the Claimants ramping up of gas production in 2007. This does not appear to be factored into the Claimants calculations of gas volumes available from the Tolwyn field from 2008 onward which gas volumes available for the LPG plant (RS Exhibit 11) far in excess of that in fact produced in excess of that actually produced (GCA figure 2). There seems little justification for this considering GCA's comment that:

“The trend of increasing water production was clearly evident at the time of the 2008 RS report, yet this was not mentioned in the report and the risk to future gas production levels was not discussed as might have been expected”.

53.17 In conclusion, the Claimants have failed to demonstrate that the necessary conditions existed for the book value of the LPG plant to be a valid proxy for fair market value. Furthermore the Claimants own evidence and that of GCA positively suggests that those conditions did not exist. Accordingly the Claimants calculation of the fair market value of the LPG plant is defective and should be disregarded by the Arbitral Tribunal.

Republic's assessment of the fair market value of the LPG plant

53.18 Deloitte have prepared a true assessment of the fair market value of the LPG plant set out in section 9 of their report. For the reasons given in paragraph 47 above the appropriate valuation date is 21 July 2010.

53.19 Deloitte determined that the appropriate valuation method was the salvage value of its assets on the basis that:

“Our cash flow projection indicates that in the foreseeable future the LPG Plant will not generate income sufficient to recover CapEx due to low capacity utilization. The calculation supports the assumption that to maximize the value of the LPG Plant it would be effective to cease the production and sell its assets. Therefore the salvage value was selected as the premise of value for the LPG Plant. This value implies that asset could be rebuilt, converted to similar or different use after dismantling if appropriate.”(Deloitte para 9.16)

53.20 On the basis of that methodology and the facts and assumptions stated in its report Deloitte determined the fair market value of the LPG plant to £24m to \$32m.

54 The Conduct of the Claimants

- 54.1 Without prejudice to the Republic's position there was no expropriation and, or no compensable expropriation, if it is established that compensation and / or damages is necessary, the Arbitral Tribunal should take into account that the Claimants by their actions intentionally contributed to aggravation of damage (operation that led to the flooding of wells) which caused serious damage to the deposit.
- 54.2 There are various factors, unrelated to the actions of the Republic, which caused the value of the Claimants' assets to deteriorate from 2008 onwards, including decreased production in KPM's operating fields resulting from flooding of the wells.
- 54.3 There is a general principle of international law that the amount of damage should be diminished in circumstances where the injured party:
- (i) intentionally or imprudently contributed to aggravation of the amount of damage caused by non performance or inadequate performance (one talks only about actions or inactivity);
 - (ii) did not take reasonable measures aimed at mitigation of damage – one talks about the cases of absence of due circumspection towards its own property or rights.
- 54.4 Article 39 of the ILC Articles on State Responsibility permits arbitral tribunals to acknowledge the *"contribution to the injury by wilful or negligent action or omission of the injured State or any person or entity in relation to whom reparation is sought."*
- 54.5 In *MTD v Chile*⁴²⁹ the arbitral tribunal permitted the reduction of damages by 50% to take account of the investor's negligence. As to the method of assessing the respective measure of the contributory negligence, In assessing the question whether such contributory negligence was correctly assessed, and in dismissing the annulment application by Chile against the award, the ad hoc committee commented as follows:
- "As is often the case with situations of comparative fault, the role of the two parties contributing to the loss was very different and only with difficulty commensurable, and the Tribunal had a corresponding margin of estimation. Furthermore, in an investment treaty claim where contribution is relevant, the respondent's breach will normally be regulatory in character, whereas the claimant's conduct will be different, a failure to safeguard its own interests rather*

⁴²⁹ ICSID Arb 01/7, Award 25 May 2004.

*than a breach of any duty owed to the host State. In such circumstances, it is not unusual for the loss to be shared equally.*⁴³⁰

54.6 The Report on the question of flooding and damage caused is enclosed (**Exhibit R-173**).

55 Moral Damages

55.1 In Section VIII, F of the SoC, the Claimants refer to a number of events in order to assert they are entitled moral damages. These are as follows:

- (a) The criminal prosecution of and a four year jail sentence given to KPM's general manager, Mr Cornegruta both of itself and in its effect that:
 - (i) Mr Cornegruta was used as an example to intimidate the Claimants and their personnel;
 - (ii) the Claimants were concerned for Mr Cornegruta's health, sanity and life; and
 - (iii) it caused suffering for Mr Cornegruta's wife and family.
- (b) Raids on the Claimants' offices shortly after Mr Cornegruta's detention searching for officers who had been charged with the same offence as Mr Cornegruta. The Claimants argue that this scared their employees and constituted incredibly hostile circumstances. It was stated that for the entire duration of this 12 hour search, employees had to stand in the corridor outside of their offices; and
- (c) The majority of the Claimants' high level management had left KZ because they feared arrest.

55.2 However, the Claimants are not entitled moral damages:

- (a) The Tribunal should note that moral damages are damages other than those for pecuniary or economic loss and may be awarded for injury/damage such as emotional harm or distress.
- (b) Whilst it is accepted that moral damages is permissible in principle, moral damages are available in very limited "*exceptional circumstances*". As was stated recently by the tribunal in *Lemire v. Ukraine*:

"[M]oral damages can be awarded in exceptional cases, provided that.

⁴³⁰ MTD v Chile,

- (i) the State's actions imply physical threat, illegal detention or other analogous situations in which the ill-treatment contravenes the norms according to which civilised nations are expected to act;*
 - (ii) the state's actions cause a deterioration of health, stress, anxiety, other mental suffering such as humiliation, shame and degradation, or loss of reputation, credit and social position; and*
 - (iii) both cause and effect are grave or substantial⁴³¹.*
- (c) The Claimants have characterised their claim for moral damages in a similar manner to the *Desert Line Projects* case where moral damages were awarded. However, the situation in Desert Line Projects differs significantly from the current case as:
 - (i) There has been no seizure of assets by armed forces as was the case in Desert Line Projects.
 - (ii) The arrest and detention of the General Director of KPM, Mr. Cornegruta was completely in accordance with Kazakh law, and as referred to above, he was liable to such a sentence as a result of principal role at KPM in operating a trunk pipeline without a license.
 - (iii) There was no removal of the Claimants equipment by armed forces as was the case in Desert Line Projects. In fact the Republic carried out all searches and audits in circumstances which cannot even remotely be compared to the circumstances described in the Desert Line Projects.
 - (iv) There was no physical threat or attack on the Claimants, its employees or its investment.
 - (v) The Claimants have not proven that there was any stress or anxiety which resulted from the alleged actions of the Republic including to Mr. Cornegruta's family.
- (d) In fact, in relation to Mr. Cornegruta he has actually escaped from jail. This was discovered and proceedings were instituted against the Chief of the Prison (**Exhibit R-169**), which casts considerable doubt on how the Claimants can bring any sort of claim for moral damages in this regard.
- (e) Accordingly, the Claimants have not established their case that moral damages are payable and this should be dismissed.

- 55.3 In any event, the Claimants overestimate the sum of moral damages
- (a) The Claimant obviously overestimates the sum of moral damages which could be awarded for imprisonment for the term of 4 years (especially, taking into account the fact that the person disappeared from jail).
 - (b) The Claimant requests a sum of far more than USD1 Million.
 - (c) One should also take into account that it requests compensation of moral damages for imprisonment of Mr. Cornegruta. In practice, Mr. Cornegruta has disappeared from jail. This was discovered and proceedings were instituted against the Chief of the Prison **(Exhibit R-169)**.

56 Interest

- 56.1 The Claimants assert that they are entitled to compound interest (SoC 469). Whilst they refer to a number of decisions where compound interest has been awarded they do nothing to bring themselves within the scope of those decisions, simply asserting without foundation that awards of compound interest are the “*generally accepted standard*”.
- 56.2 The question of payment of complicated, compound interest, interest on interest seldom arises in international practice and where it does, Arbitration practice in general is that compound interest should be denied.
- 56.3 For instance in *R.J. Reynolds Tobacco Co. v. Iran* the Tribunal noted “[t]here are few rules within the scope of the subject of damages in international law that are better settled than the one that compound interest is not allowable”. (**Starrett Hous. Corp. v. Iran, 16 Iran-U.S. Cl. Trib. Rep. 112, 252 (1987) (Exhibit R-192)**)
- 56.4 As it is stated in Paragraph 8 (article 38) Text of the draft articles with commentaries thereto: “*An aspect of the question of interest is the possible award of compound interest. The general view of courts and tribunals has been against the award of compound interest, and this is true even of those tribunals which hold Claimant to be normally entitled to compensatory interest*” (**Exhibit R-104**) .
- 56.5 Therefore, in general, both doctrine and practice are against compound interest.
- 56.6 Even where compound interest is awarded, there are usually particular circumstances which justify such an award. For instance in *Metalclad Corp. v. United Mexican States*, The tribunal only determined that an award of compound interest was appropriate because it would restore

⁴³¹ Joseph Charles Lemire v. Ukrain, ICSID Case No. ARB/06/18, Award, 28 March 2011, para, 333. The threshold defined in the LEMire case was cited with approval by the tribunal in Tza Yap Shum v. Republic of Peru, ICSID Case No. ARB/07/6,

the claimant to a “reasonable approximation of the position in which it would have been if the wrongful act had not taken place.” (Exhibit C-226 para 128) As noted above the Claimants have done nothing to demonstrate that compound interest is necessary here and the Republic denies that the Claimant are entitled to such an award.

- 56.7 As for the rate of interest the Claimants suggest it might be appropriate to apply the rate of interest applicable to certain notes guaranteed by KPM and TNG (SoC 468). However this is proposed without the slightest justification as to why this is appropriate on either a fact or legal basis and the Claimants deny that this is the appropriate rate. .
- 56.8 The Permanent Court of International Justice in the Award in the case of vessel «Wimbledon» awarded interest at 6% (see Paragraph 2 of article 38 of the Text of the draft articles with commentaries thereto, Exhibit R-104).
- 56.9 In the Award in the case Factory at Chorzów the Permanent Court awarded payment of interest having defined them as a sum equivalent to 5%.
- 56.10 Generally interest in interstate claims is awarded at a lower rate than in commercial claims. Thus, in the 1999 Award in the case of vessel «Saiga» the International Tribunal on the Law of the Sea awarded interest at different rates in respect of different categories of losses (see Paragraph 3 of Article 38 of the Text of the draft articles with commentaries thereto, Exhibit R-104).

57 Claim for interest on Notes issued by Tristan Oil

- 57.1 At paragraph 467 of the SoC the Claimants make the wholly outrageous claim that they are entitled to be compensated for interest penalties it is alleged that Tristan Oil has made on certain loan notes guaranteed by KPM and TNG. Tristan oil is alleged but not proved to be related to the Claimants.
- 57.2 The Republic strongly denies that the Claimants are entitled to any such compensation, firstly and most obviously any such payments represent losses of Tristan Oil Ltd that is a stranger to these proceedings and could never be since it is understood to be a company registered in the BVI (FTI 3.3) which is not a party to the ECT. Therefore Tristan Oil could never be an Investor for the purpose of the ECT.
- 57.3 Further the Claimants have failed entirely prove how any liability on the part of Tristan Oil arose from the Republic's actions.

PART 5: DECLARATIONS

58 Declarations

The Republic requests the Arbitral Tribunal to award the following:

- (a) a declaration that the Claimants' claims are dismissed; and
- (b) an award for reimbursement of the costs of the arbitration and related expenses.

I.V. Zenkin

Norton Rose LLP



21 November 2011