



Oil&Gas Bulletin

The KPMG Oil & Gas Practice
in Kazakhstan and Central Asia

June 2016

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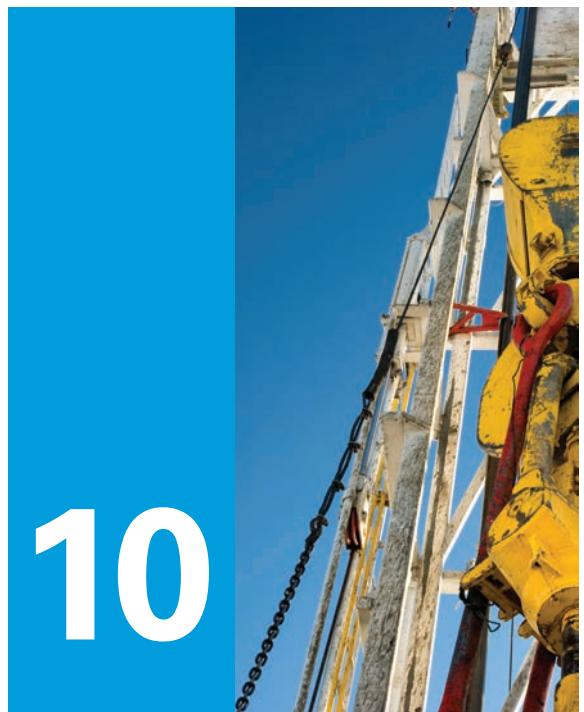
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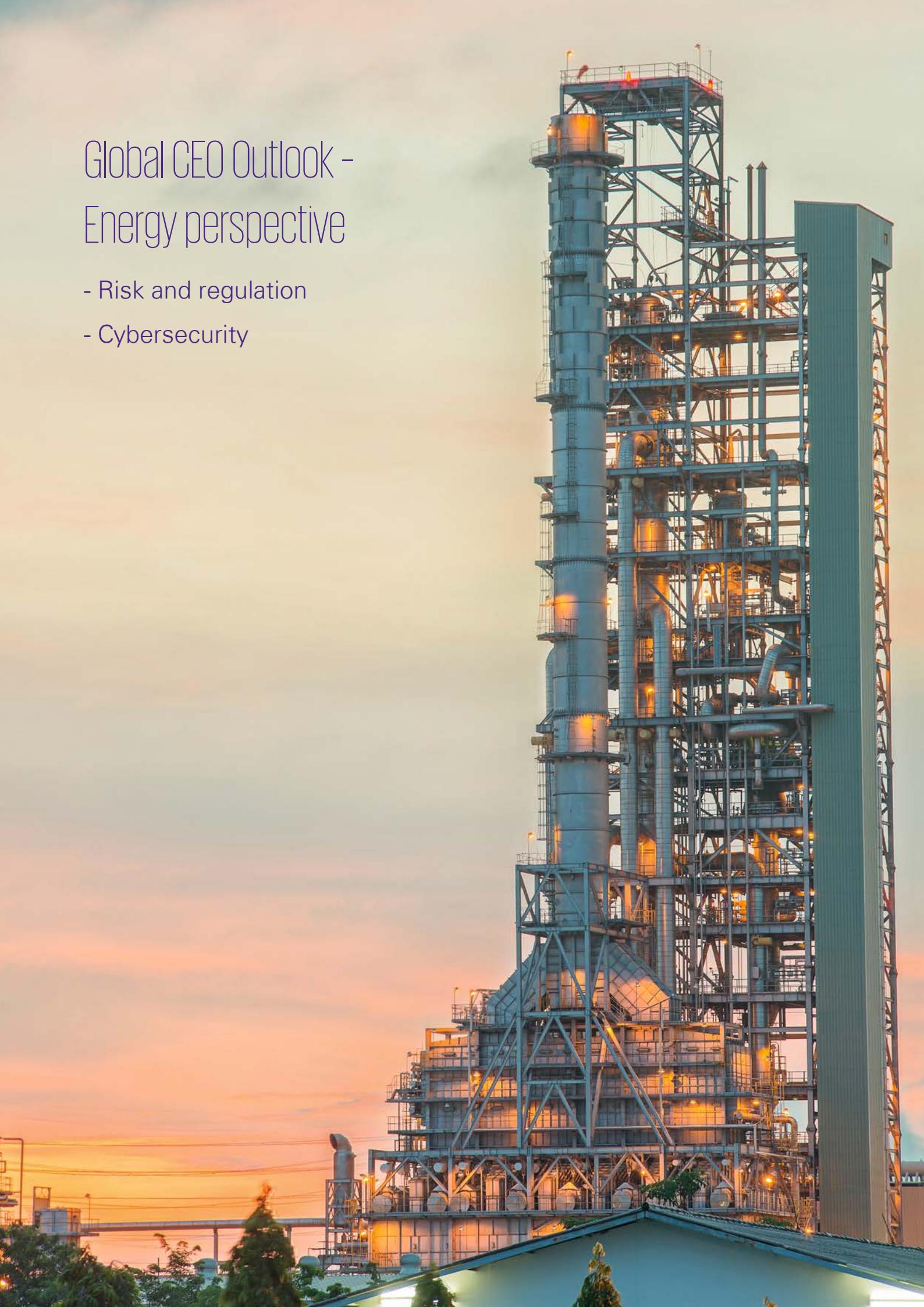


Unsung workhorses of the oil industry



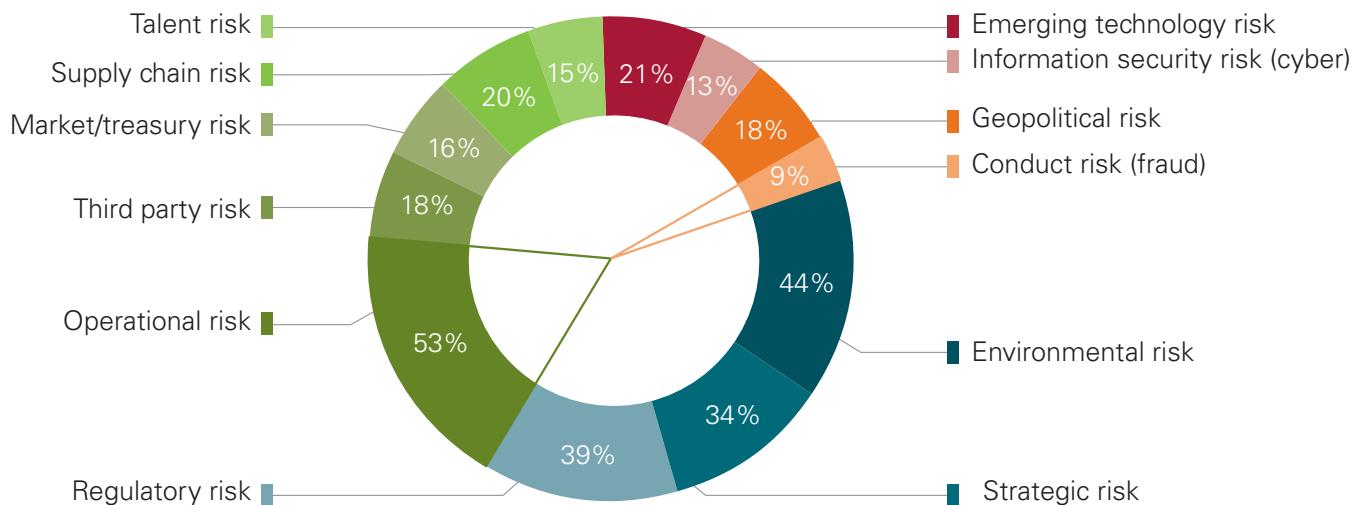
Global CEO Outlook - Energy perspective

- Risk and regulation
- Cybersecurity



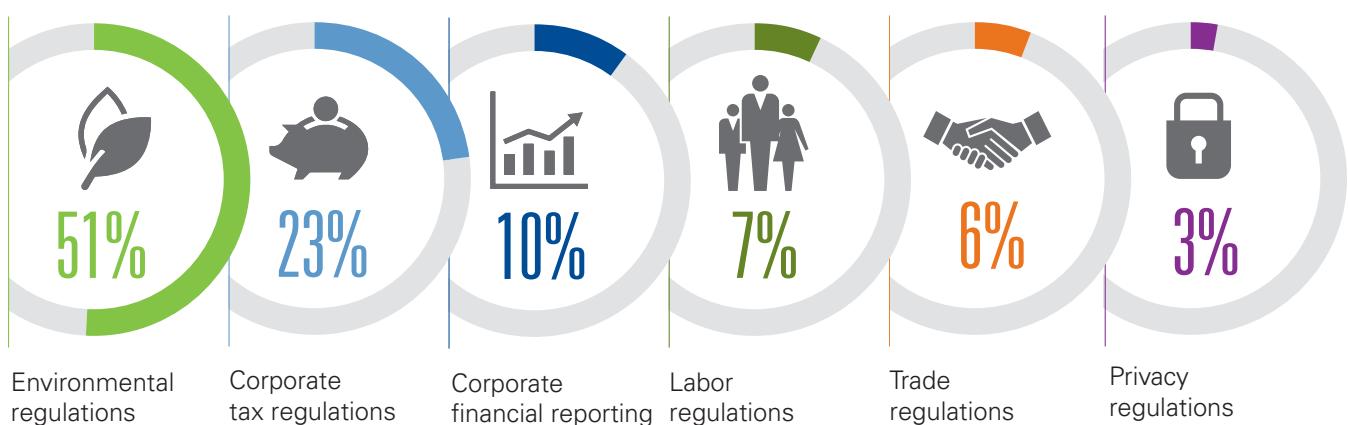
Risk and regulation

Which of the following risks are you most concerned about?



CEOs are concerned most about **operational risk** at 53 percent and least about **fraud** at 9 percent.

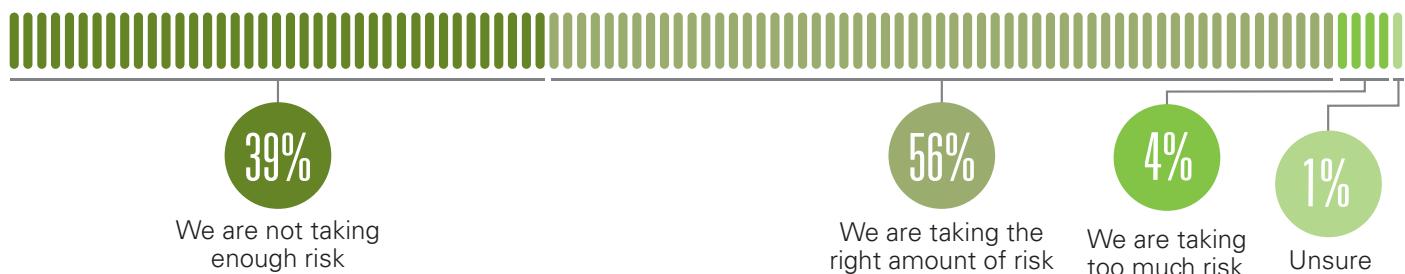
Which of the following areas of regulation are you most concerned?



Energy CEOs are not surprisingly most concerned about **environmental regulations** (51 percent). Of lowest concern for energy CEOs is **labor regulations** (7 percent), **trade regulations** (6 percent) and **privacy regulations** (3 percent).

Which statement best describes your risk profile as it relates to your growth strategy?

Income



CEOs are taking the **right amount of risk** at 56 percent best describes their risk profile as it relates to their growth strategy.

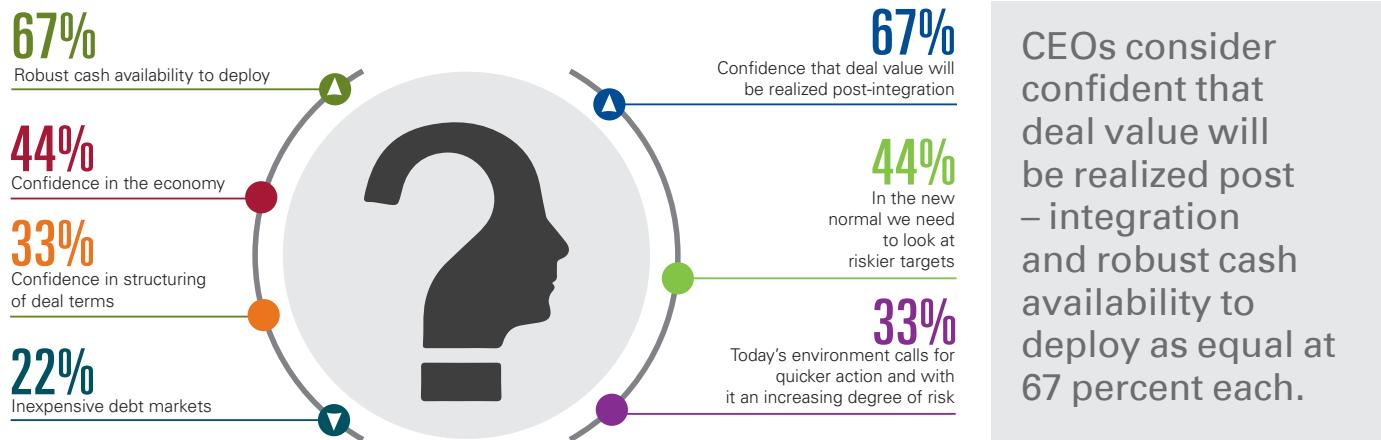
How would you characterize your current approach to acquisitions in terms of risk taking?



Sixty-two percent of CEOs are focused on taking **less risk** while 6 percent are willing to take on **more risk**.

Risk and regulation (continued)

Why are you willing to take more risk with acquisitions?



Looking further



Vital risk insights

Success in today's global marketplace demands that leading companies keep up with the remarkable pace of technological change and innovation, particularly in regard to business intelligence software. Capturing market share often involves taking advantage of social media solutions such as apps on smart phones and tablets, interactive visualization, and scenario modelling. Such solutions are also becoming important tools for tracking the effectiveness of governance, risk management, and compliance activities.

Further insight

There is no doubt that executives are aware of the need to manage risk; it is clearly seen as a high priority within energy companies. However now, more than ever, CEOs need to be equipped with greater insight and specificity as to how much risk their companies are taking overall and how much more capacity remains to take on additional risk. Thirty-nine percent of energy CEOs feel their organizations are not taking enough risk with their growth strategy, but how will they really know when they are?

Only a small minority of energy companies have a clear articulation of their overall risk capacity and appetite for risk. Those that do often characterize appetite in terms of general statements (e.g., we have a low risk appetite for compliance risk) to communicate levels of risk-taking that they have agreed with their board that they will not go beyond. Very few have connected risk appetite with the objectives at risk in their strategy to use it not only as a decision-making tool, but one that answers: 'Are we taking enough risk?'



Michael Wilson

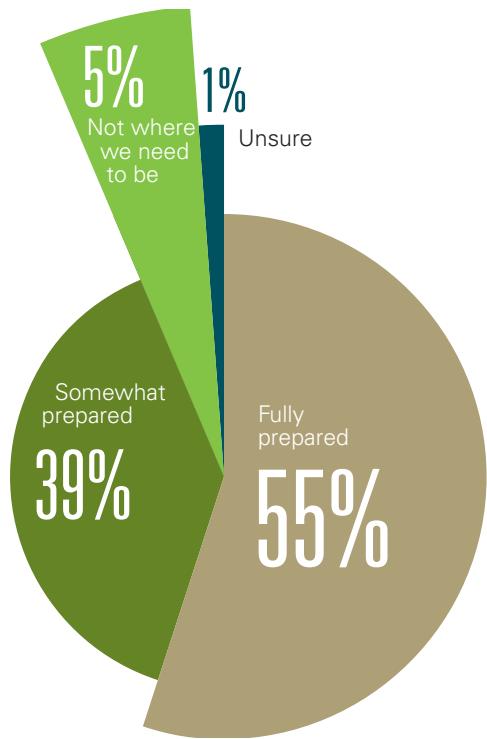
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Michael has 24 years of experience which includes evaluating and designing governance frameworks & risk management programs, assessing board effectiveness, designing risk and compliance reporting frameworks, conducting best practice/benchmarking reviews, and helping companies implement ERM and GRC programs.

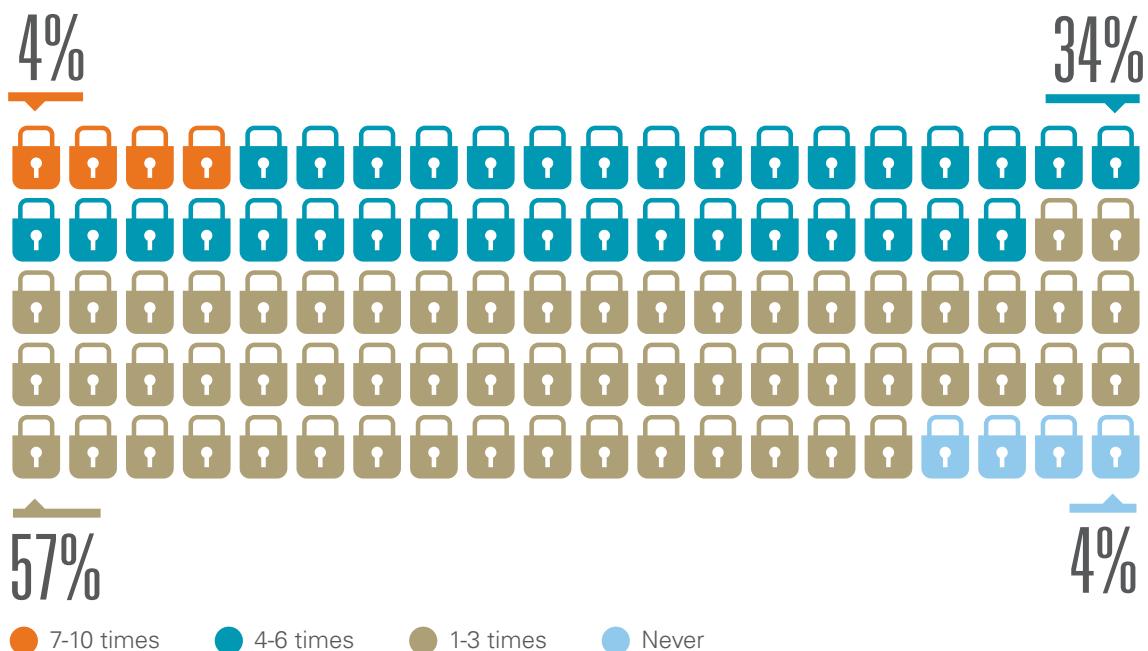
Cybersecurity

How prepared is your company for a cyber event?

Fifty-five percent of CEOs believe their companies are fully prepared for a cyber event.



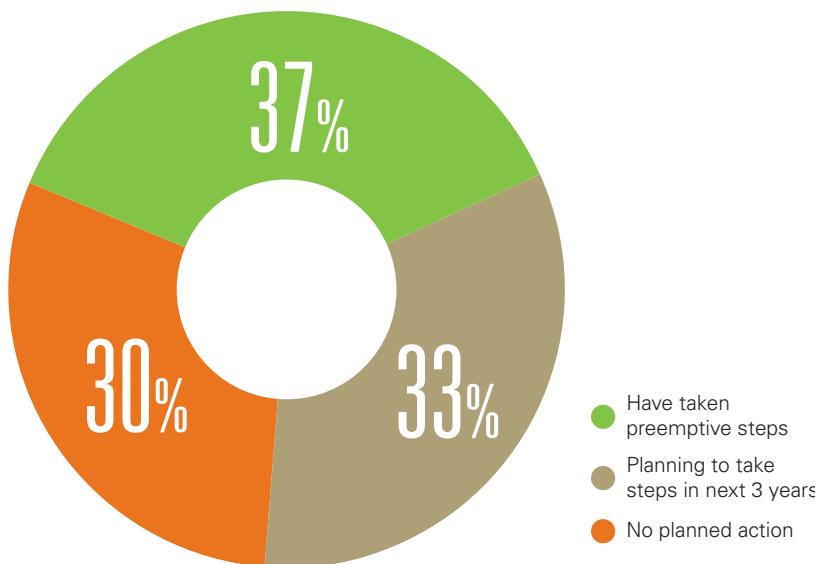
How often have you met with your executive team and/or board of directors on cyber security?



CEOs have met 4-6 times 57 percent and never at 4 percent.

Cybersecurity (continued)

Steps taken to prevent a cyber security breach



Thirty-seven percent of CEOs have **taken steps** to preempt a cyber security breach, 30 percent report they have no plans.

Hire a cyber security consultant.



30% Have taken preemptive steps

59% Planning to take steps in next 3 years

11% No planned action

Fifty-nine percent plan to hire a cyber security consultant in the next 3 years.

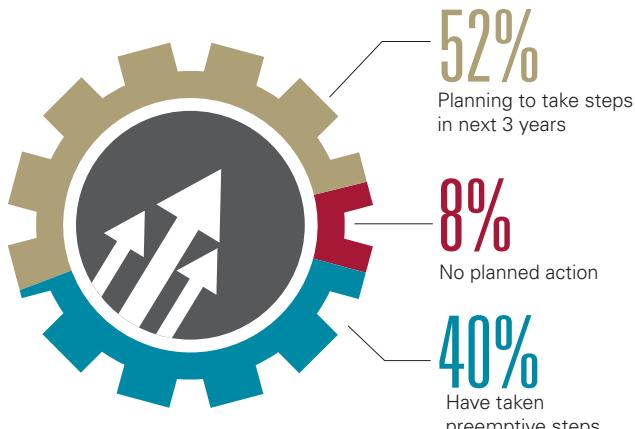
Looking further



Read more: Cyber Insight Magazine

Cyber security professionals express their views, sometimes conflicting, on collaborating in the space of cyber security: Can it ever truly be achieved? What are the challenges for effective collaboration? And, how can we work to enable collaboration between small, innovative tech firms and large organizations? It is a contentious topic that divided opinion within the team. But instead of forcing a consensus, we created a platform to allow our subject matter experts the space to have their say.

Upgrade current technologies



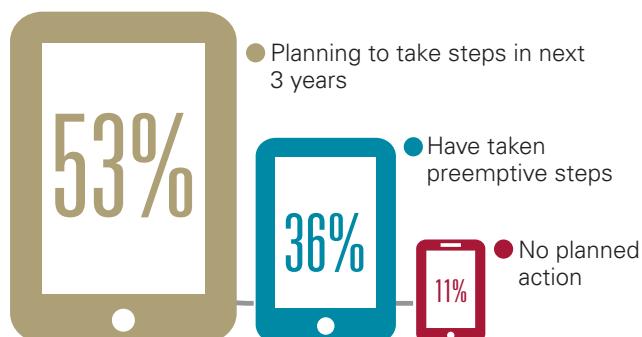
Fifty-two percent of ENR CEOs are **planning to upgrade** their current technologies in the next three years and 40 percent have already taken **preemptive steps**.

Deploy new technologies



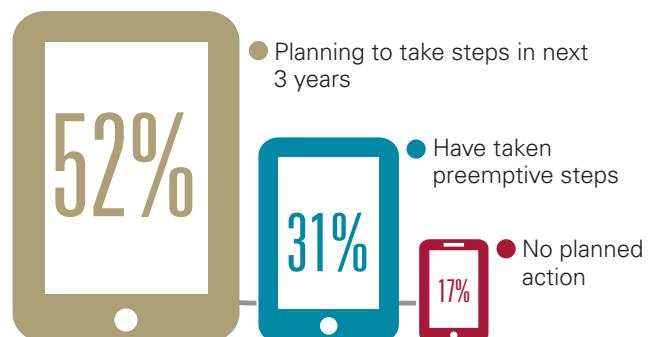
Eighty-four percent have or plan to **deploy new technologies** in the next 3 years.

Changed internal processes (data sharing, device use etc.).



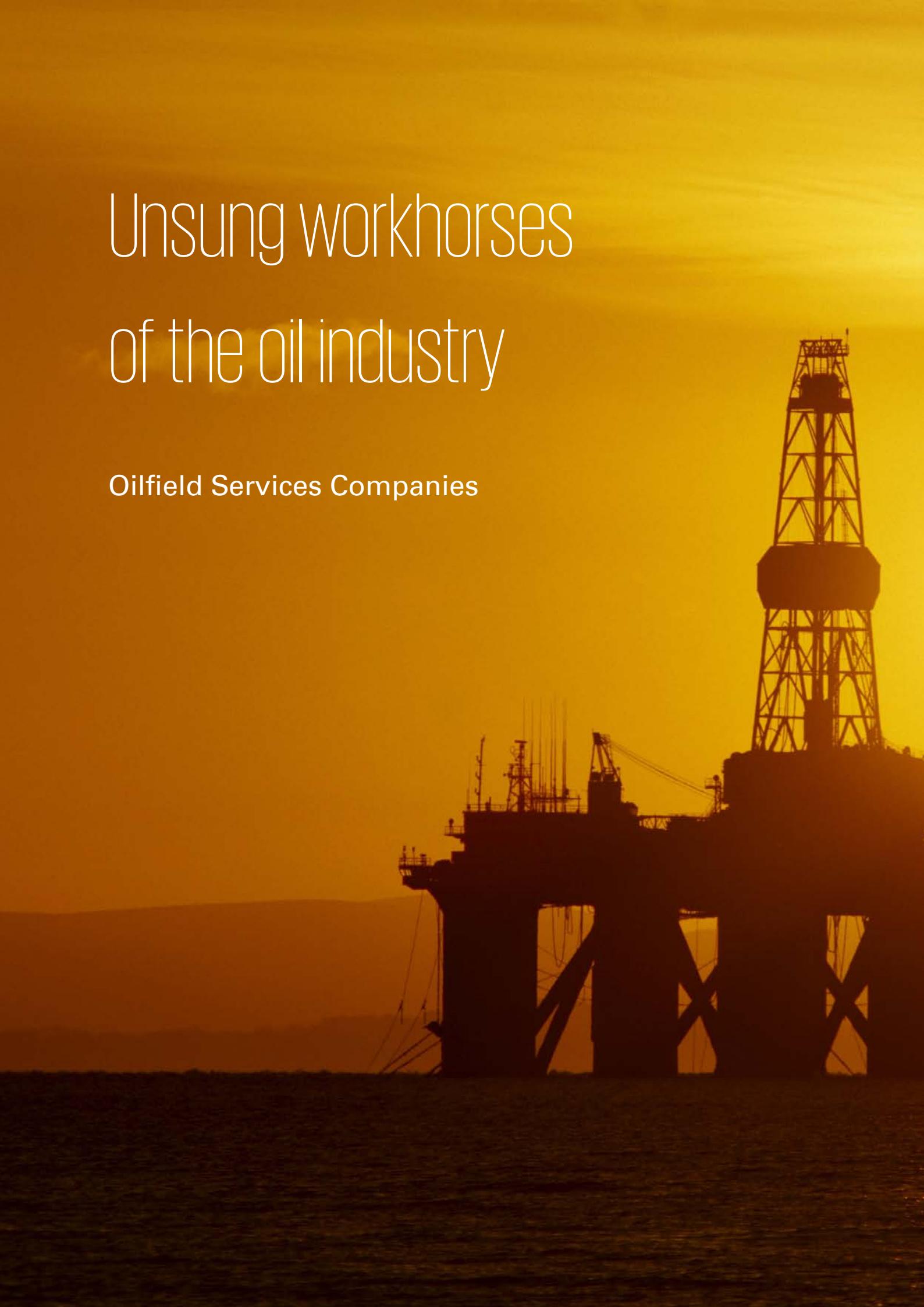
Eighty-three percent plan to or have changed internal processes such as data sharing, transaction processing or device use.

Changed external processes (data gathering, transaction processing, data sharing etc.).



Unsung workhorses of the oil industry

Oilfield Services Companies



Unsung workhorses of the oil industry

Over time, oil companies have increasingly become asset portfolio owners, more at arm's length from the execution of operations and support services needed to perform these.

Oilfield services companies have established themselves as the heavy lifters of the oil and gas industry (or, as the Economist put it, "Unsung workhorses" or "Masters" of the oil industry — depending on your point of view — by leading both the delivery of operations and the innovation space.

The critical support they offer to operations and their handle on technological solutions have enabled national oil companies and independents to manage much more complex projects than they would have otherwise, and the IOCs over time have also become more dependent on oilfield services companies and increasingly followed an outsourcing model.

As oilfield services companies grow into this space, they typically handle more risk. The distinction between the two sides of the industry remains, although there are a few examples of hybrid operating models.

The whole industry is facing significant challenges resulting from the low oil price environment. E&P companies have been pushing the supply chain to aggressively lower costs which in turn is impacting margins. This is hitting the service sector by reducing

capacity utilization and lowering rates, to which service companies are responding by downsizing.

However, if oil companies just see oilfield services companies as a commodity and keep a vendor at arm's length, they will not be getting an oilfield services company's most thoughtful application of its knowledge to a specific project. We believe that the operators will become more dependent on services companies, as they did in the 1990s during the oil price slump, for technologies solutions to extract oil more cheaply. The key technical challenge will be to optimize technology integration to reduce costs.

Out of mutual necessity, the current low oil price environment may accelerate the trend to new operating models, leading oil services companies and oilfield companies into new partnerships through which risk can be shared and project delivery optimised on a longer term life-of-field basis.

The trend within the sector towards more integrated services to operators will lead to service sector consolidation, as the larger and more dynamic services companies continue to build capabilities and competencies over a wider range of activities. This in turn will make them better placed to support new partnerships and new operating models with IOCs, NOCs and E&P independents that can address cost issues in the industry.

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Introduction

Historically, the world's biggest oil producers closely guarded their role as operator of their own fields — convinced they alone could deliver the engineering necessary to extract their oil on time and on budget. Increasingly, however, over recent decades those producers have been ceding that role — opting in many cases to manage their assets at arm's length, and allowing the world's increasingly sophisticated oilfield services companies to deliver cost-efficient production and, crucially, the oil-field innovation that Big Oil has long assumed it alone could deliver. The speed and manner in which this has occurred varies somewhat by geographic market.

The critical support service companies offer to operations and their handle on technological solutions have enabled national oil companies, integrated majors and independents to manage much more complex operations than they would have otherwise. Despite today's sharp retrenchment and consolidation among the world's service companies — driven by the

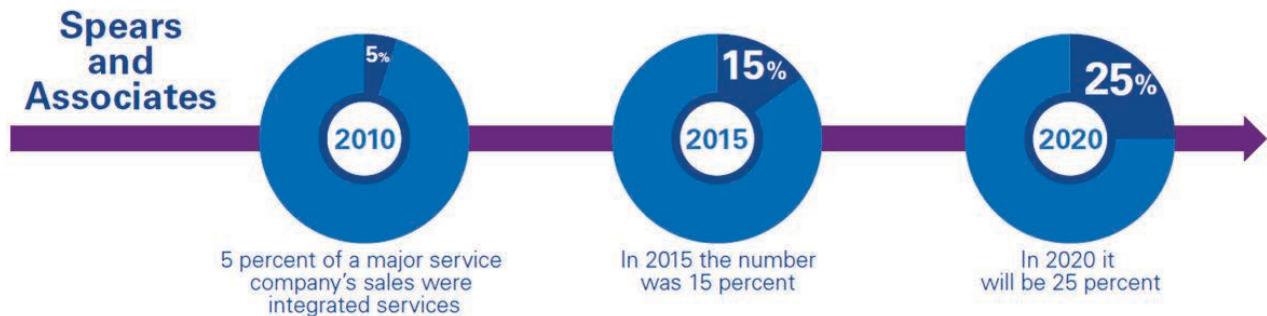
stubbornly low oil price — these companies, from US giants Schlumberger, Halliburton, Weatherford and Transocean to major international players such as Technip, Wood, Aker and Petrofac, continue to offer technological solutions for operations.

As oilfield services companies grow into this space, they handle more risk. The current low oil price environment may accelerate that trend, leading them and oil company operators into new partnerships through which risk can be shared and project delivery optimized.

This thought leadership piece has also carried out unique research of the service company sector in various regions, to uncover the level of technical sophistication of the indigenous service companies and the potential for local value-added-content — an issue of great importance to governments hopeful of developing a high-tech service industry in their country. The results of this regional analysis appear in the back of this report.



The critical role of the oilfield services providers



Oilfield services companies provide the products and services necessary to construct, complete and produce oil and gas wells. Companies range from giant Schlumberger, whose divisions provide nine out of 10 products and services needed to explore, develop and produce an oil and gas basin, to a single, service company like Geolog, specializing in surface data logging for international and offshore drilling projects.

What makes this diverse group a unique actor in the petroleum sector is its relationship to oil company operators. A manager from a leading French oilfield services company explained that oilfield services companies are in the first row of a project's pyramid of services and their function is to select and integrate technologies into the project delivery.

The growth of the oilfield services sector is very much a story of innovation and finding solutions to technological and cost challenges faced by operators. "It is a solutions-driven industry," explains Alan Kennedy of KPMG. Companies grow by developing proprietary technologies and know-how that can be applied across particular projects which then become an accepted industry service and way of operating. Their specialization and repeat use of services allow them to achieve economies of scale on technology development — something oil companies cannot do to the same degree.

Integration

The industrial evolution of the service sector is also characterized by integration of services. Companies strive to offer more services across the value chain. Schlumberger has the widest provision of services along

the whole value chain, but competitors have similar strategies and this is, for example, Baker Hughes-Halliburton.

In the NOC market, it has been driven by the customer's preference for 'single company' and 'single contact' solutions. These drivers are well explained by Waleed Al Hashash, a former Deputy Managing Director at KPC, Chairman of Aref Energy and CEO of Rubban Logistics Kuwait: "Most NOCs would love to see these (big service company) guys more because they do everything in one contract. And this is something good for somebody who is tied up with a long chain of local government tender procedures. So you talk to someone like Schlumberger and they can bring you your breakfast to the derrick, as well as huge equipment under contract. The Schlumberger philosophy is propagating while small companies push to be able to offer more services."

According to Spears and Associates, in 2010, 5 percent of a major service company's sales were integrated services. In 2015 the number was 15 percent and in 2020 it will be 25 percent. The industry is moving toward integrated project management handled by service companies and this model favours the major service companies.

US onshore may be less likely to follow this path to integration because the US supply chain is a well-oiled machine, according to Richard Spears. Shale wells in Turkey, for example, may cost US\$20 million, while the same well in the Eagle Ford costs US\$6 million thanks to the available and competitive supply chain. This difference illustrates the potential downside to the industry from integration, as it threatens to reduce the very competition that lowers costs and stimulates innovation and research.

Outsourcing: A driver for the service industry

Until the 1960s, the oil majors handled the multiple facets of operations in-house and they conducted in-depth research into drilling, completion and production technologies. In the 1980s, these were then licensed to the oilfield services companies. Functions such as drilling yielded low margins and diverted the attention of operators and they increasingly outsourced them to specialized companies with a greater ability to drive efficiency. They encouraged the establishment of companies to handle these services, such as drilling, reservoir engineering, procurement, construction, laying down pipes, supporting ongoing production and maintenance. Since that era, however, oil companies have not maintained the same level of in-house expertise in technology research and development.

The consequence of outsourcing technology development

Services that were initially low value grew more sophisticated as oil prices fell in the early 1990s and operators required technological innovations to develop oil more cheaply and access new geology. In this cost-cutting era, oil companies decreased their R&D expenditure, while service companies ramped up investment. This led to breakthroughs in 3D seismology and directional drilling.

Today, some oilfield services companies spend more on R&D than oil companies as a share of total revenues. The service companies have incentives to do so: they can effectively sell their technology to multiple customers. Innovation has segmented the industry between service companies focused on developing technology and carrying out execution and oil companies integrating multiple technologies and managing overall risk.

Risk management

Oil companies take on financial risk and are ultimately responsible for the outcome of projects. They manage relations with the host government and communities. And in addition to political and above-ground risks, oil company operators decide where and how to explore (based on geophysical data provided by an oilfield services company and sometimes upon their advice). In this sense, the oil companies' technological skills are largely interpretative.

Pete Nolan, previously with BP and now an adviser to a private exploration company, explained how oilfield services companies and oil companies approach and take responsibility for risk differently. "The primary difference is the scale of risk and how that risk is underwritten. A private oil company competes when risks (uncertainty and capital exposed to this uncertainty) are very high and it shows its willingness to put very large amounts of its shareholder capital at risk to achieve greater value. The service company competes by promising greater value to the oil company through its investment in technical research and acceptance of performance incentives (and penalties). The service company does not accept huge uncertainties or expose its shareholders' capital to these uncertainties."

Partnerships for managing risk

The complexity of projects and the ability of companies active in the oil sector vary widely. Naturally, the best marriage is between an operator capable of managing risk, with a strong process focus and technical ability on the one hand, and a service company that is equally capable on the other. But in an industry where small independent companies have proliferated and national oil companies have secured the majority of proved reserves, the operators of projects are not always sufficiently experienced to handle all technological decisions during operations. In practice, oil companies have been able to rely increasingly on oil field service companies to share some of the burden of technological decisions and risk management.

A good match in skills and abilities between the operator and the service company is key to the successful outcome of the project. A manager from a leading French oilfield services company commented that a company the size of Tullow does not have the same in-house resources as ExxonMobil. These companies work differently and their relationship with service companies is also quite different. "Tullow will give the oil service companies a greater level of responsibility in the project." It will not be as involved in detailed technical decisions or oversee as closely their work. "But that said, their project will be less complex than ExxonMobil's and they will have made sure that they selected the right service companies." Jean-Matthieu Castellani, former head of the Total account for Schlumberger, warned of a risk because some oilfield services companies wanting to respond to the needs of customers "may step in to do things that they are not accustomed to do or particularly expert at. It is important to differentiate between service companies who have real capabilities to deliver integrated services and those who do not."

The critical role of the oilfield services providers (continued)

For independent oil companies over reliance on smaller service companies presents risks. Processes are required to minimize the risk of adverse events and these may not be the forte of oil service companies. As Zoe Thompson, KPMG in the US explained, "Chevron, BP and other majors have a process for decision-making — who approves what and when." The largest service companies do too. But many of the mid-size oilfield services companies, especially the smaller ones, do not share this process focus. "If you ask them how they plan to approach and measure the risk related to foreign corrupt practices in a country where they are set to operate, for instance, they do not have a standardized way of assessing and mitigating that risk that they can apply to that case. They reinvent the method each time." On the flip side, these smaller companies are "nimble and entrepreneurial." And some will say that innovation requires an entrepreneurial and unstructured search for solutions to technological challenges... and perhaps a willingness to be less conventional and assume more risk. The burden is then on the oil company operator to work more diligently to manage risk throughout the chain of services.

Addressing industry cost challenges

The service sector is facing significant challenges resulting from the low oil price environment. When comparing capital investments plans for the following two years in Q4 2014 and Q4 2015, Wood Mackenzie saw

a decline of 28 percent, amounting to a US\$286 billion investment hole. Wood Mackenzie estimates that US\$1.5 trillion of investment does not break even at US\$50/bbl.¹ E&P companies have been pushing the supply chain to reduce margins and lower costs. This impacts the service sector through reduced capacity utilization and lower rates, especially in the US where the investment pullback is most pronounced. Spears and Associates estimated the market to be US\$454 billion in 2014, but in 2015 it fell to US\$332 billion and is estimated to fall further to US\$294 billion in 2016. But the operators will come back to the service companies, as they did in the 1990s during the oil price slump, for technology solutions to extract oil more cheaply. The key technical challenge will be to optimize technology integration to reduce costs.

Oil companies can share risks and rewards with service companies. By changing partnership terms to engage the service provider as a partner holding equity in a project, operators will create new incentives for service companies to apply their knowledge to the benefit of the project and to mitigate risks. Such new partnership models are a natural evolution for well-established operator NOCs and service companies, which are already acting within a more collaborative framework, sharing vital information about projects. Sharing financial risks and rewards would solidify this partnership and ensure the service mobilizes its best resources for the project, works to mitigate risks and fills any gaps left by the NOC operator.

¹ Insight, Cost deflation outlook: upstream sector responds to low oil prices, 8 September 2015



Regional markets focus

In many petroleum-producing countries, an indigenous service sector has grown over the years, expanding services offered. This development is important for the countries involved because, as the North Sea and American methods demonstrate, industrial clusters around the upstream oil and gas projects create jobs and drive innovation. It is also important to understand the level of sophistication and ability of these indigenous service providers because, as we saw, operators are increasingly relying on the oilfield services companies sector to carry out operations.

Our report reviews the oilfield services companies sector developing in various parts of the world. We focus first on the US, by far the largest in terms of market size and number of companies. Small, medium and large OSCs drove key innovations in unconventional gas and oil extraction. Second, we examine China, where investments in R&D are very high. A unique feature in China is that these service companies are subsidiaries of NOCs, which gives these companies a different set of incentives. In Russia, the market is relatively diversified, with a number of NOCs and vertically integrated companies, which have some in house services and employ global and local oilfield services companies.

We then turn to the Middle East, which is the most important market for the international OSCs. The reserves there are large and low cost, and this has enabled local oilfield services companies to grow their business. But the NOC operators are facing increasing technical challenges.

And finally, in the North Sea, a sophisticated and well-established service sector has nurtured the growth of some of the world's largest oilfield services companies.

US market

In the case of the US oilfield services companies, there is a segment of activity that is US-focused or indeed state-focused, as well as another class of players that has an international scope. In this section we will examine more carefully the former.

The United States, long a net importer of crude, saw energy independence on the horizon amid the explosive rise of what some in the industry called "Cowboyistan"

— Texas' Permian and Eagle Ford basins and the Bakken in North Dakota. These three plays drove half of the global production growth since 2008 and combined were the seventh-largest liquids producer in the world. With oil hovering at US\$100/bbl and 1,931 active rigs², the future for US oil and gas production looked promising — and the industry responded with a proliferation of smaller, specialized oilfield services companies to meet strong demand.³

A little more than a year later, crude is less than US\$40/bbl and the rig count has dropped by over 60 percent to a five-year low of 709.⁴ The oil price change and corresponding drop in drilling activity has had a particular impact on these domestic-focused oilfield services companies. Less diversified geographically or with the services they provide, they have fewer response alternatives than their larger peers. Despite cutting costs and laying off personnel, contracting demand for services has inevitably impacted financial returns for the oilfield services companies sector.⁵ While the bigger companies cut prices to maintain or improve market share, the smaller players simply cannot compete. Many have been forced into bankruptcy; the lucky ones have become targets for larger companies with stronger balance sheets.

The industry has seen that wellcapitalized companies are looking for acquisitions to fill gaps identified in their product or service offerings. As is common in cyclical downturns the first rounds of M&A focused on diversification, as a means of helping to endure the difficult industry environment. Geographic diversification may be out of reach for some of these smaller players, but Duff & Phelps Securities sees companies assessing diversification outside of their current oilfield services companies market activities. "Certain oilfield services companies equipment manufacturing and fabrication business are targeting acquisitions that would provide them access to the general industrial and downstream petrochemical industries. Market diversification often seeks to apply the company's core competencies, such as metallurgy and engineering, in industries that may be countercyclical to their OFS business activities."⁶ Small to mid-size oilfield services companies are also showing interest in stock merger transactions, which draw less on their liquidity. The question for many is when the timing will be right to take advantage of the vulnerabilities of the weaker companies. Will crude prices and rig counts continue to slide, therefore providing even better bargains?

² <http://marketrealist.com/2015/07/highest-us-rig-count-rise-year-whats-impact/>

³ <http://newsok.com/article/5397907>

⁴ <http://phx.corporate-ir.net/phoenix.zhtml?c=79687&p=irol-rigcountsoverview>

⁵ Standard & Poor "Negative Outlooks Prevail For US Oilfield Services Companies Amid The Commodity Price Slump", June 8, 2015

⁶ Oil and Gas Financial Journal, 8 June 2015; available at: <http://www.ogfj.com/articles/print/volume-12/issue-6/features/what-lies-ahead-in-ofs-sector.html>

Regional markets focus (continued)

China

The Chinese service sector is among the most developed. The market is still centrally planned to a large degree, with high barriers to international company participation. Indigenous company growth has been driven by this protected market and strong ties to the Chinese NOCs. Indeed many of the service companies are subsidiaries of the NOCs.

These companies spend a lot on R&D: PetroChina stands out as the top spender in absolute terms on R&D among all oil and gas companies. However, Richard Spears, a long-time industry observer, has commented that the Chinese NOC model does not incentivize innovation because as subsidiaries of the NOCs they are not spurred by competition to outperform their peers.

A degree of opening in the services sector could be required to significantly move the trajectory of unconventional gas development in China. Some Chinese firms are already venturing abroad to gain access to new technology solutions. The wellhead systems expert Plexus Holdings, for instance, entered into a partnership with China Oilfield Services, majority owned by the NOC CNOOC, and will work with Red Sea Technologies and Yantai Jereh Oilfield Services to explore commercial opportunities for shallow water subsea and crossover wellhead production systems in China.

Russia

The Russian oilfield services market has grown rapidly over the last decade. Drilling remains the leading oilfield service, comprising around 65 percent of all oilfield services. But Russian companies have extended their scope of work to include advanced well stimulation and enhanced oil recovery techniques.

This growth was triggered by a general activity boom resulting from new projects. Major Russian oil and gas companies disposed of their oilfield services divisions as non-core assets which were not as competitive as the independent Russian service companies. The Russian market diversified, with indigenous and foreign oilfield services companies of various sizes offering services. Sanctions are changing the picture by limiting the access of large foreign oilfield services companies to the Russian market. Local oilfield services companies have an open field to provide a full scope of services, if they prove capable of meeting the requirements of operators. For now, there is a gap left by the large foreign players

and Russian oil majors have begun to revive their previously outsourced service divisions. Russian oil companies have also demonstrated an interest in establishing joint ventures with foreign players, in order to get access to foreign technologies, offering in exchange a share of local market and projects. *Insight, Cost deflation outlook: upstream sector responds to low oil prices, 8 September 2015.*

Middle East

Producers in the G.C.C. and Iraq are a key market for the largest oilfield services companies, especially as those NOCs have come to depend increasingly on service companies for operations over the past two to three decades. New entrants from China, Korea and Canada are gaining market share in a region historically dominated by the established international players.

However, some trends are emerging which point to a greater involvement of indigenous companies. First, local private oilfield services companies are increasingly active in the Gulf. While such companies had traditionally been simple agents, offering foreign companies the label of 'local content' in exchange for an equity stake, new companies are being created in Oman, Kuwait and Saudi Arabia, with a view to taking an active role in the business. Waleed Al Hashash, who has worked in this sector and for the Kuwait national oil company, explained these local private companies now put up equity to form joint ventures with foreign OFS companies. "You get respect in the Gulf because you're local and you're putting in the money, learning the know how and chasing tenders like anybody else. You're not sitting there like an agent, just a messenger, going back and forth." Some of these companies are listed and operate throughout the region.

This trend will no doubt be helped by Saudi Aramco's decision in December 2015 to increase the share of local service companies in projects. The In-Kingdom Total Value Add (IKTVA) programme seeks to double the percentage of locally manufactured energy-related goods and services to 70 percent by 2021 and to raise the export of Saudi-made energy goods and services to 30 percent over the same time frame.

In Iran, the local oilfield services companies sector has prospered since the mid-2000s as US and then international sanctions prevented many international oilfield services companies from entering the market. There are hundreds of Iranian companies active in the energy sector.

Aliakbar Vahidi AleAgha estimates that most of these are in the chemical, engineering and manufacturing sectors, four to five companies are "small oil companies, carrying out a number of functions," and "20 to 30 are service companies with very particular upstream oil expertise," including offshore and onshore drilling, logging, wireline and cementing. But the big service companies are needed. Cementing services, for instance, are limited by restrictions on imports of chemicals which only a few big names produce. Safety standards are lower too and much of the equipment used is out of date and corroded by time. "When sanctions end, international service companies will return. But they will not monopolize the market."

North Sea

The North Sea market, both in the UK and Norway, is one of the most developed in the world, with particular expertise in deep water and hostile offshore environments. It is home to many local indigenous service companies. Many of these, such as Wood Group, Aker, Technip and Petrofac, have evolved over the past few decades from local bases to become major international players. Much of the technical capability and know how built up in the North Sea has been exported to other regions. For example, a significant proportion of global subsea developments are run and managed from this region.

Norway in particular has a strong tradition of technological innovation, which has helped the industry tackle more challenging subsea formations, water depth and climates, and which has made local technology companies attractive acquisition targets for larger groups with the international reach and distribution networks to exploit the sales opportunities from these technologies.

The region is however a relatively high-cost province, which in the current oil price environment presents additional challenges for operators and service companies, as discoveries become smaller and field economics more marginal. The industry is trying to react through more collaboration, industry standardization and more technological innovation. This may provide a blueprint for wider industry cost initiatives and business models in other territories. For example, with the maturing of the basin, managing end-of-life fields and decommissioning are now becoming a real source of activity within the region, which as experience in this area grows, may lead to service companies in this region becoming global decommissioning leaders as skills learned in the North Sea are again exported to other regions.



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