

## Strategic overview

# Independent Directors' statement

Dear Shareholders,

Over the course of 2015 and during the 2016 year to date, the Independent Non-Executive Directors ('INEDs') have experienced challenging times with respect to the corporate governance of KMG EP. The INEDs believe that shareholders should be aware of those challenges, and set out below a brief summary.

## Proposed offer from NC KMG

Shareholders will recall the proposed offer from NC KMG that was announced in July 2014 to acquire all the shares it did not already own in the Company. After receiving that approach, the INEDs engaged with KMG EP's minority shareholders, and with NC KMG and its advisers, with a view to achieving a satisfactory transaction. In December 2014, the INEDs wrote to NC KMG stating that they would recommend the proposed offer to all shareholders, subject to agreement on the level of a dividend to be paid in respect of the year ended December 31, 2014. However, NC KMG subsequently withdrew its proposal on January 5, 2015, when it issued an announcement citing "ongoing volatility in the oil market and the inability to reach an agreement on price" as the reasons behind its withdrawal.

## Dividend

KMG EP continues to hold substantial cash balances and despite the strong balance sheet, it has neither acquired any significant oil and gas assets nor substantially invested in exploration in recent years. In view of this, the INEDs have recommended to the Board that KMG EP should return its surplus cash to shareholders by way of a special dividend. The INEDs have proposed such a special dividend in each of the past three years, but on each occasion (including in the year ending December 31, 2015) the NC KMG majority controlled board has rejected the INEDs' recommendation.

## 2015 Domestic Oil Price Agreement

The Relationship Agreement entered into between NC KMG and KMG EP at the time of KMG EP's IPO ('the Relationship Agreement') required KMG EP to supply oil to Kazmunaigas Trade House (now KMG RM) for the domestic market in specified volumes and at a price of cost +3%, up to and including

2015. Cost is calculated as the cost of producing one tonne of crude oil, together with the cost of transportation and general and administrative costs. Between 2012 and 2014, KMG EP supplied oil to the domestic market at a margin to cost of production above three per cent.

During 2015, KazMunaiGas Refining and Marketing JSC (KMG RM) unilaterally made payments to KMG EP at an average price per annum of 21,288 tenge per tonne at the Atyrau refinery and 31,923 tenge per tonne at the Pavlodar refinery. These prices were not approved by KMG EP's INEDs, as they were below the agreed cost +3% level. Following extensive negotiations between KMG EP's management, NC KMG and KMG RM, an agreement was reached to settle the price for domestic supplies in 2015 at 37,000 tenge per tonne at both refineries ('the Supply Agreement'). This price is approximately equal to the estimate of cost plus three per cent in accordance with the terms of the Relationship Agreement.

At the time of writing this report, KMG RM has failed to pay the sums due pursuant to the Supply Agreement.

## 2016 Domestic Oil Price Agreement

The volume obligation in the Relationship Agreement to supply oil to KMG RM expired at the end of 2015. However, the Kazakh Government continues to require that KMG EP supply the domestic market. Following the expiry of the volume obligation in the Relationship Agreement, KMG RM proposed prices for domestic oil supply that were unacceptable to KMG EP. KMG RM subsequently served a formal notice refusing to purchase oil after March 1, 2016.

Failure to meet the Kazakh government's domestic supply requirement would result in KMG EP losing its licence to export oil. The Board of KMG EP, therefore, decided to have the required volume of oil refined at Atyrau and Pavlodar for a fee under a tolling arrangement (whereby KMG EP retains ownership of the oil) and to sell the resulting products into the domestic market. This processing scheme commenced with effect from April 1, 2016. A transitional price is currently being negotiated with respect to the first three months of 2016 on the basis of the netbacks generated by the processing scheme.

## The Relationship Agreement

In November 2015, NC KMG published proposals ("Proposals") to effect changes in the Relationship Agreement as set out at the time of KMG EP's IPO in three key areas:

- to amend the Relationship Agreement and the Charter of the Company so as to enable NC KMG to have control of the Company;
- to amend the methodology for valuation of shares, which sets the price at which certain buybacks by the Company must be undertaken and which is embodied in the Charter of the Company; and
- to provide support for the Company in buying back shares/GDRs from shareholders within a set timeframe and at a predetermined price.

NC KMG justified its Proposals as necessary to give KMG EP the "benefit of the wider Group's expertise and experience in key areas, reduce duplication, improve focus and decision making and significantly reduce cost".

The INEDs were, and remain, in principle, fully supportive of the aim of achieving operational efficiencies. However, KMG EP must maintain its own adequate procedures, systems and controls to enable it to comply with its UK listing obligations.

Moreover, the Company already accesses NC KMG's technical expertise that allows for the delivery of meaningful efficiency improvements without requiring any amendments to the Relationship Agreement or Charter, and without compromising both the Company's independence and the commitments made at the time of the Company's IPO. NC KMG has, to date, failed to explain to the INEDs why it requires the Company to discard these minority protections to achieve efficiencies, which are already in place.

In September 2015, KMG EP further supported the drive to greater efficiency with the formal transfer of eleven of its employees to the NC KMG Transformation Initiative team. KMG EP's participation in that transformation programme has not been precluded or inhibited by the terms of the Relationship Agreement. KMG EP has also supported the newly established NC KMG Technical Institute (the "Scientific Research Institute of Production Technology and Drilling") to improve productivity. The INEDs commend the professionalism and initiatives of the Technical Institute which complements the work of the Company's own executives. The Technical Institute has proposed a number of initiatives to improve production in existing wells by deploying more electric submersible pumps (ESPs), implementing hydraulic fracturing where cost effective and drilling horizontal wells and sidetracks. Efficiencies of this type would deliver considerable benefit to KMG EP.

The INEDs believe that a cultural conservatism towards change within the wider KMG group, rather than the terms of the Relationship Agreement, may be responsible for impeding a faster realisation of these efficiencies. In short, the Relationship Agreement is a protection for minority interests and in no way inhibits progress, where such progress is possible.

The Proposals overall are intended to significantly augment the role of NC KMG as the controlling shareholder. At present, through its shareholding in KMG EP, NC KMG appoints a majority of the Company's Board of Directors, including both the Chairman and CEO of the Company, who are key to all operational decision making. NC KMG, therefore, controls the business of the Board of Directors (including matters such as dividend policy) other than the few matters, which require the approval of a majority of the INEDs under the Charter, such as amending the Charter, the placement of shares in the Company, decisions on major transactions and on related party transactions and decisions on delisting the Company's shares.

The INEDs believe that the amendments as proposed in November 2015 represented an undue curtailment of minority interests and that operational efficiencies are achievable by continued cooperation on the lines described above.

The INEDs are continuing to discuss with NC KMG their Proposals, which at the date of this letter, have not been finalised by NC KMG. As and when the Proposals have been finalised, the INEDs will provide KMG EP's shareholders with their recommendations with respect to them.

## Conclusion

We, the INEDs, are confident that we can work together with NC KMG and our capable management team to meet our shared aim of achieving operational efficiencies and creating maximum value for all shareholders. The INEDs will continue to ensure that any changes to the corporate governance arrangements of KMG EP, including the Relationship Agreement, continue appropriately to protect the rights of minority shareholders of the Company.

### Philip Dayer

Independent Non-Executive Director of KMG EP

### Alastair Ferguson

Independent Non-Executive Director of KMG EP

### Edward Walshe

Independent Non-Executive Director of KMG EP