Kenya’s petroleum fiscal regime

Expansive coverage

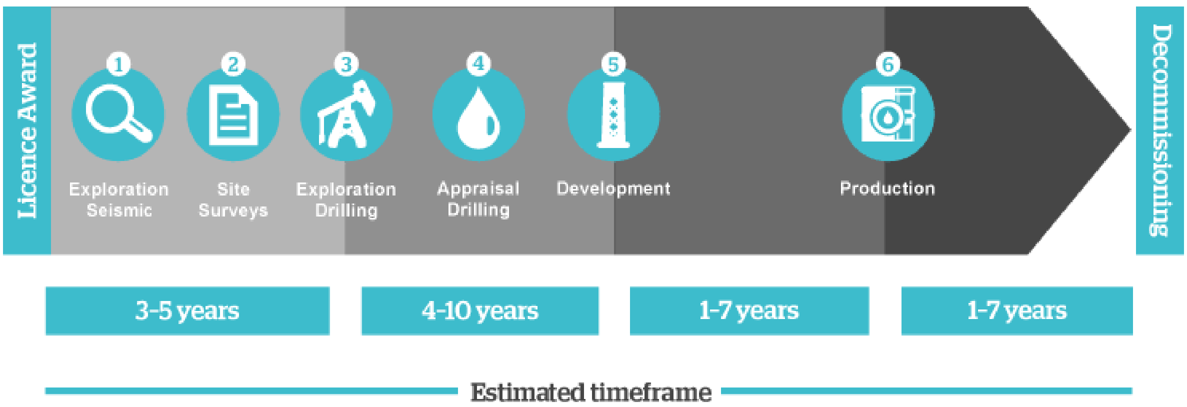
October 2014
(Includes the 2014 Finance Act Amendments)

Table of contents

1 Introduction

Plans to develop the recently discovered petroleum resources in Kenya are gaining traction. Arrangements defining the framework for development operations including drafting new petroleum legislation are in high gear. Developing and commissioning the necessary infrastructure to harness these resources is projected to cost several billions of US dollars. Exploration activities to exploit the country's promising geological potential must also continue and a public private partnership (PPP) model involving greater collaboration with the private sector is contemplated as a means of achieving these objectives. The unprecedented scale of investment required especially at development stage is significantly beyond the reach of many domestic investors to play a leading role in the sector.

Lifecycle of the petroleum industry[1]



The government of Kenya (GoK) also understandably allocates most of its budgetary resources towards social services delivery which limits its ability to invest upfront in the sector. The implication of this is that all countries in the region – Kenya, Uganda, Tanzania and Mozambique – are vying for the limited FDI pool.

This publication provides an in depth discussion of Kenya's petroleum fiscal and tax regime including the most recent changes ushered in by the Finance Act 2014 most of which come into effect on 1st January 2015.

[1] http://www.cairnenergy.com/index.asp?pageid=324> accessed on 25th September 2014

2 Definitions

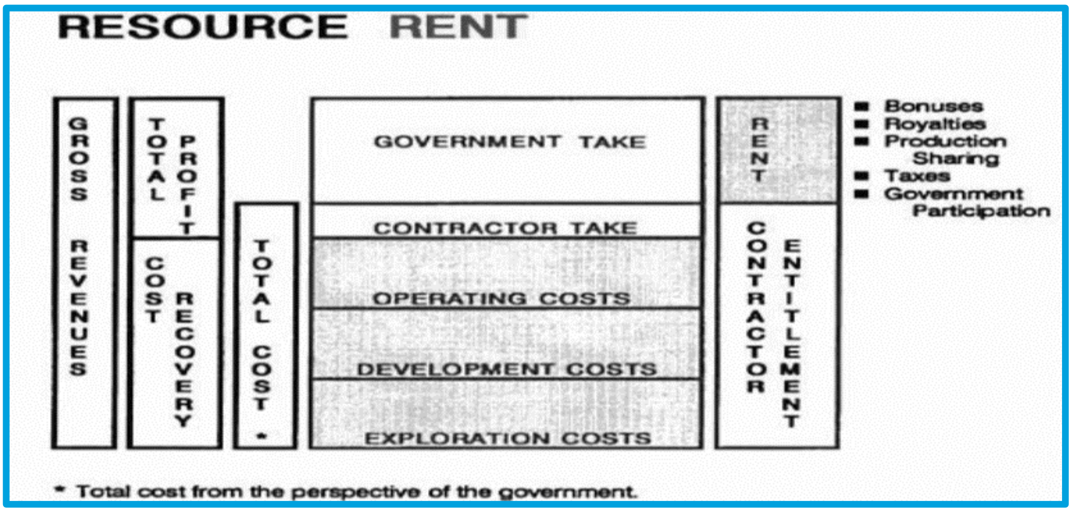
Unless the context otherwise requires, the following words and terms used in this publication have the meaning ascribed to them below:

1. APT: Additional Profits Tax;
2. BIT: Bilateral Investment Treaty;
3. BOPD : Barrel Of Oil Per Day;
4. CGT: Capital Gains Tax;
5. EACCMA : East African Community Customs Management Act, 2004;
6. Gok : Government of Kenya;
7. IOCs : International Oil Companies;
8. ITA : Income Tax Act;
9. MIT : Multilateral Investment Treaty;
10. MPSA : Model Production Sharing Agreement;
11. NOCK: National Oil Company of Kenya;
12. PEPA : Petroleum Exploration and Production Act;
13. PPP: Public Private Partnership;
14. PSA : Production Sharing Agreement;
15. RDL : Railway Development Levy;
16. RRT : Resource Rent Tax;
17. RSA :Risk Service Agreement;
18. USD : United States Dollar;
19. VATA: Value Added Tax Act, 2013.

3 Overview of petroleum fiscal regimes

Petroleum fiscal regimes blend legal and contractual instruments setting out the framework for carrying out petroleum operations. They also encompass levies, taxes and related financial approaches of allocating economic rent arising from petroleum operations between the government and the IOCs.[2] Economic rent is the difference between production and the costs to extract the petroleum resources as the figure below illustrates.[3]

Illustration of economic rent[4]



Resource rich countries normally rely on IOCs which have the financial means and technical expertise to exploit petroleum resources efficiently. Countries in turn rely on fiscal tools such as taxation, levies, bonuses and royalties to extract the economic rent deriving therefrom.[5] The discussion below outlines the various fiscal tools generally deployed in the petroleum sector. We will subsequently describe in detail the petroleum fiscal tools employed by Kenya in section 3.

---

[2] Johnston, Daniel. *International exploration economics, risk, and contract analysis*. PennWell Books, 2003 at page 1.

[3] These include the normal exploration, development and operating costs as well as an appropriate share of profit or return for the IOC.

[4] See supra note 2 at page 7

[5] Ibid page 6

Royalties

These are also known as severance or production taxes. They are broadly categorised into two types, namely: specific or ad valorem and are levied on the extraction of natural resources.[6] Specific royalties are based on the quantity of the resource extracted, while ad valorem are charged as a percentage of the value of the resource. Specific royalties have the advantage of ease of administration, provide early revenues and are equally not affected by a fall in prices. Government revenues, however, do not rise if resource prices increase nor keep up with inflation. Ad valorem royalties address some of these concerns through valuation based on prevailing commodity prices.

Royalties are typically taken right off the top of gross petroleum production but there are variations embedded in some countries' petroleum regimes that take into account defined costs incurred in production to arrive at the net base amount on which royalties are computed.[7] Royalties in their traditional form can be regressive and thus unpopular with the oil companies.[8] It is a commonly expressed reservation that royalties can lead to premature closure of resource operations if the prevailing prices are insufficient to cover the marginal costs plus the royalty.[9]

To overcome this, some countries have introduced a profit element in royalty schemes based on production through the sliding scale system or deducting specified costs from the royalty base. Under the sliding scale with variations of the incremental and slab schemes, royalties rise with the level of production. Both schemes define the production threshold levels and the royalties thereto. The difference between the two is that under the incremental scheme, the higher level of royalty is payable on incremental production while under the slab scheme, the higher level of production is payable on the entire production not just on the incremental production. The deduction method provides that some costs incurred in production can be removed from the gross production in arriving at the net production on which royalties are computed.

Kenya Model Production Sharing Agreement (MPSA) does not provide for royalties.

Resource Rent Tax

This is also known as Additional Profits Tax. APT provides the government with a greater share of economic rent yet it distorts investment decisions less. APT crystallises if the accumulated net cash flow from the petroleum project is positive and can be categorised into two, namely the r- factor based and the rate of return schemes. R factor based APT links taxation to the investment payback ratio (the

---

[6] Daniel, Philip, Michael Keen, and Charles McPherson, eds. The taxation of petroleum and minerals: principles, problems and practice. Routledge, 2010.The taxation of petroleum and mineral resources. Page 27.

[7] Daniel Johnston. International petroleum fiscal systems and production sharing contracts. PennWell Books, 1994 page 53

[8] See supra note 2 at page 154

[9] See supra note 6 at page 27

r-factor) which is defined as the ratio of the IOC's cumulative receipts over the cumulative costs including the upfront investment. APT in this case applies when the r-factor exceeds one. On the other hand, the rate of return APT applies after a target rate of return on the investment has been realised. The cumulative positive net cash flow is determined by reference to a discount rate which mirrors the opportunity cost of capital in the country's petroleum sector.[10] When the project cash flows turn positive, the target rate of return is assumed realised and APT applies on the profits above this threshold.[11]

While APT is lauded as a progressive fiscal tool by investors, government revenue stream becomes back-loaded. The government may not receive any revenue at all for less profitable projects that do not achieve the targeted rate of return. Countries rarely rely solely on APT. It is usually supplemented with royalties and standard corporation taxes that provide some early revenue. The practice in most countries is to target APT for only very profitable projects.

Kenya MPSA does not provide for resource rent tax.

Brown tax

Brown tax was originally proposed by E. Cary Brown in 1948 from whom the name derives.[12] Projects generating positive cash flows are taxed at the applicable rate, but a cash refund is made to the investor when there is a negative net cash flow. Brown tax entails the highest level of risk to the government. If a project turns out unprofitable, the government may have to make unending cash refunds to the investor if the project generates negative cash flow all through. In practice, Brown tax is rarely applied in its purest form. It is supplemented with royalties and standard corporation taxes.

Kenya MPSA does not provide for Brown tax.

State participation

Governments may participate directly in petroleum projects by taking up an equity stake. Sharing in the upside of the project as well as exercising greater control in project development and direction are some of the motivations for governments to participate in these projects.[13]

---

[10] Baunsgaard, Thomas. A primer on mineral taxation. International Monetary Fund, 2001 page 8.

[11] Ibid

[12] See supra note 2 at Page 33

[13] Sunley, Emil, Thomas Baunsgaard, and Dominique Simard. "Revenue from the oil and gas sector: Issues and country experience." Davis, Ossowski, and Fedelino, Fiscal Policy Formulation (2003) page 9

Forms of state equity participation[14]

Equity stake	Discussion
Paid up equity on commercial terms	The equity stake in a project is acquired at prevailing commercial terms.
Paid up equity on concessional terms	The equity stake in a project is acquired at concessional rates below the market price.
Carried interest	The IOCs initially foot the petroleum expenses which the government reimburses from production proceeds.
Free equity	The government acquires an equity stake in the project freely as the title suggests without making any contribution or payment.

Equity participation can potentially be costly to the government because it has to foot its share of the capital and operational costs related to the project. There are also likely conflicts of interest that may arise given the government's role as regulator which may be inconsistent with its commercial objectives as a shareholder.[15]

Auctions

Countries employ different methods of granting petroleum rights that include informal processes such as first come- first serve or other auction based processes where companies submit exploration and development plans with the highest paying or scoring bidder based on the criteria set granted the petroleum rights.[16] Proponents of auctions as a means of granting petroleum rights contend petroleum blocks are assigned to the party that is best able to use them. Auctions are popular with governments because they generate revenue upfront.

Production sharing

Under production sharing, the state as owner of the petroleum resources engages an IOC to find and extract the resource for a share in production. The investor is allowed to recover the exploration, development and production costs incurred in their operations before sharing the remainder production with the government. This however only happens in the event that discovery and development occur via what is known as cost oil or cost recovery.[17]

[14] Ibid

[15] Ibid

[16] Cramton, Peter. "How best to auction oil rights." Escaping the resource curse 5 (2007): 114-151.

[17] See supra note 13 at page 33

It is common for PSAs to limit the amount of production available each accounting year for cost oil purposes and this is known as the cost recovery limit. If the operating and capital depreciation costs are more than the allowable cost oil, the balance is carried forward and recovered in subsequent periods.

Bonus payments

Bonuses represent payments made upon the signing of petroleum contracts hence the term signature bonuses.[18] Bonus payments are typically cash based but can sometimes consist of equipment and technology.[19] Another form of bonus dubbed the production bonus is paid by the contractor to the government when production commences or reaches a particular milestone.[20]

Export taxes

Export taxes are not that prevalent anymore. Levies may be imposed on natural resources exports to restrict global supply with a view to controlling world prices. In other instances, they are imposed to encourage the domestic processing and value addition activities of the natural resources in the country of extraction.

Corporation income taxes

Most countries include petroleum projects within their standard corporate tax regime though a higher tax rate may be applied to collect more economic rent. This approach may not require the introduction of a separate tax regime given the stakeholders are already familiar with the legal and operational framework of the corporation tax regime.[21]

In its pure form, standard corporation tax typically applies to the consolidated operations of an organisation. Under a petroleum regime, the subject of taxation is commonly the operations of individual projects under ring-fencing arrangement. This means that an organisation operating one project while developing a new project cannot reduce its taxable income by combining revenues and expenses from the different blocks. Ring-fencing is introduced to protect the tax base, which could otherwise be eroded through unremitting deductions.

---

18 See supra note 2 at page 52

19 Ibid

20 Ibid

21 See supra note 10 at page 6

Import duties

Customs duties are imposed on most goods imported into a country. Though they are usually levied to protect domestic industries, they are one of the most important source of government revenue but can significantly increase the cost of imported raw materials, components and capital goods.[22] Much of the specialised equipment and consumables used in the petroleum industry in developing countries is imported. Most countries exempt oil and gas projects from importation taxes.[23]

Withholding taxes

Another means of extracting economic rents is the application of withholding taxes on interest, dividends, natural resource payments, royalty payments and specified service payments that are paid to non-resident persons who have sourced income from the resource rich country.[24]

Value Added Tax ("VAT")

VAT applies on most items and is principally borne by the final consumer. VAT registered businesses can claim the VAT incurred on their inputs for business purposes. VAT should thus have little impact on petroleum projects if the contractors are registered for VAT. Petroleum projects however have long lead times between investment and production implying the contractors may have to wait for a significant number of years to register for VAT until they start production. Unless a contractor is registered for VAT, their ability to claim the VAT incurred on their business operations is compromised. This non claimable VAT may escalate project development costs with the potential to render projects uneconomic.

Fiscal stabilisation clauses

Investment in the petroleum industry is long term, large scale and upfront, which raises concerns for investors to guard themselves against unforeseen changes to investment financial projections through variation of the fiscal framework.[25] One safeguard mechanism is the inclusion of stabilisation clauses in project agreements.[26] Stabilisation clauses can restrain a government from unilaterally abrogating the terms of the agreements. Stabilisation clauses aim at ensuring that the fiscal terms of the agreement executed are not altered to the disadvantage of the investor during the duration of the project. While stabilisation clauses can seem attractive to the government in the short run as a cheap

---

[22] Shah, A., & Slemrod, J. (1991). Taxation and foreign direct investment. Tax Policy in Developing Countries at page 54

[23] Ibid at page 44

[24] Ibid at page 51

[25] See supra note 10 at page

[26] Walde. "Thomas and George Ndi, "Stabilizing International Investment Commitments: International Law versus Contract Interpretation,"." Tex. Int'l LJ 31 (1996): 215-230

way of minimising investor risk, they may have costs in the long run through limiting government's ability to modify tax policy.

Capital gains taxes ("CGT")

CGT is generally imposed on profits realised on the sale of non-depreciable and non-inventory assets that are purchased at a cost amount lower than the amount realised on sale. Some countries do not tax capital gains at all or tax only a limited range of gains.[27] Some countries provide exemption from CGT provided the gains arising from the disposal are reinvested in the country. Farm down transactions in the petroleum sector are usually targeted for capital gains tax in most developing countries.

Annual fees

Most countries require petroleum companies to pay annual rental fees for the acreage held. There could be additional impositions such as training fees to facilitate the training of government officials and other personnel that are involved in the country's oil and gas industry.

Stamp duty

Stamp duty is charged on the legal recognition of certain legal documents. In the context of the upstream petroleum industry, the chargeable instruments to which stamp duty could apply can include assignment deeds or other related instruments that confer rights.

Local government taxes

These represent taxes assessed and levied by local authorities to fund a wide range of local authority services. Local governments of areas where the oil and gas projects are located can impose these provincial levies.

Environmental taxes

Environmental taxes are aimed at curbing or reducing the extent and amount of the use or consumption of harmful substances or activities, or depletion of a resource.

Local content

Local content generally means the added value brought to a host nation through the activities of the oil and gas industry. Oil companies may therefore be obliged to employ local staff, invest in supplier development, as well as procuring goods and services locally.

[27] See supra note 22 at page 48

4 Kenya's petroleum fiscal and taxation regime

This section provides an in depth discussion of the petroleum fiscal tools deployed in Kenya. As the country approaches the development phase of its petroleum resources, the importance of fiscal regimes in influencing investor behaviour, including attracting new investment, cannot be overstated. Designing and implementing a sound fiscal system for the sector is magnified by the fact that fiscal regimes touch on a number of relevant aspects that include the investor's plan of exploration and discovery, scale of investment, rate of production, scope of enhanced recovery operations as well as the timing of final abandonment. Fiscal terms also determine the extent to how big a petroleum discovery must be to justify commercial development.[28]

Fiscal regimes take into account country settings and other trade-offs in an attempt to create an environment that is competitive enough to address the concerns of the two principal stakeholders, namely the government and the private sector.[29] A far-sighted regime considers a variety of circumstances that include deep-water, high versus low prospectivity, different cost environments as well as substantial fluctuations in oil prices.[30] It must have built in flexibility and efficiency all aimed at providing a more stable investment environment.[31] An overly generous fiscal regime weakens government returns and can sow seeds of an adverse political backlash for the country yet again a very tough one can stifle the incentives for oil companies to invest in the sector hence reduced FDI.[32]

Legal framework of the fiscal regimes

There are two broad systems of granting petroleum rights to investors, namely the concession and contractual arrangements that consist of PSAs and RSAs.[33] The system used by the government influences the amount of FDI that a country can attract. IOC's have a penchant for concessions and PSAs over RSAs because of the preferential possibility of recognising in their books their entitlement

---

[28] See supra note 2 at page 8

[29] Ibid at page 157

[30] Ibid

[31] Ibid

[32] See supra note 6 at page 90

[33] Duval, Claude, and H. de Leuch. International petroleum exploration and exploitation agreements: legal, economic and policy aspects. Barrows, 1986. page 57

of hydrocarbons.[34] The concessionary system originated with the very beginning of the petroleum industry in mid-1850's[35] and still predominates in OECD countries.[36] As the term suggests, concessionary systems allow the private ownership of resources which is rooted in the Anglo-Saxon legal tradition.[37] Ownership of the petroleum is vested into the IOC at wellhead subject to the payment of royalties and taxes.[38]

Contractual systems comprise the PSA and RSA and in both the government retains ownership of the petroleum. PSAs were popularised by Indonesia in the 1960s a period of raging nationalistic hostility towards foreign IOCs and their concessions.[39] PSAs were reluctantly accepted by IOCs and are now the leading system for allocating petroleum rights to oil companies in developing countries. Under the PSA, ownership and right to exploit the petroleum resources remains with the state but an IOC is hired as a contractor to undertake the exploration and exploitation activities.[40] The state retains title and ownership of petroleum extracted but the contractor is reimbursed costs incurred by way of entitlement to a portion of that oil and an additional share of profit oil.[41] The contractor bears the exploration and development risks and is not compensated in the event of project failure.

RSAs are used in countries where there is opposition to concessions or even PSAs.[42] RSAs represent an arrangement whereby the state hires an IOC both for its technical and financial capability to assume the role of contractor in petroleum exploration and exploitation. RSAs have some resemblances with the PSAs in the sense that the IOC bears the financial risks and is reimbursed for its sunk costs only if it succeeds in commercialising production. The difference lies in the mode of sharing the profit oil. Under a PSA, the contractor is entitled to a predetermined share of profit oil. Under a RSA, the contractor's cost recovery and profit share are determined according to a mutually agreed upon formula. Payment of the service fee is usually made in cash and not in kind as is the case under the PSA unless there is a buy back clause.[43]

---

[34] Ibid

[35] See supra note 6 at page 93

[36] Ibid

[37] Daniel Johnston. International petroleum fiscal systems and production sharing contracts. PennWell Books, 1994 page 21

[38] See supra note 33 at page 57

[39] Bindemann, Kirsten. Production-sharing agreements: an economic analysis. Oxford: Oxford Institute for Energy Studies, 1999. page10.

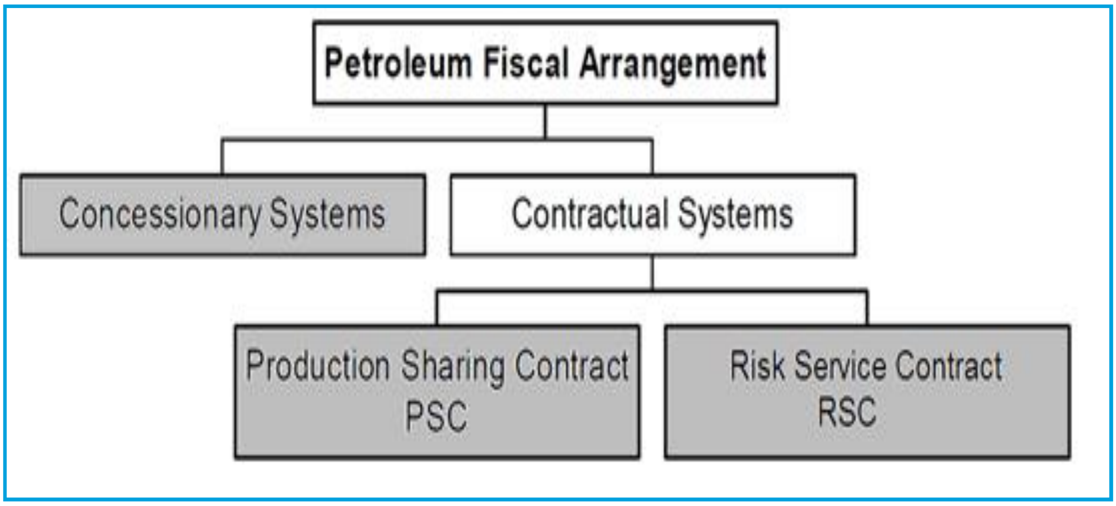
[40] See supra note 33 at page 57

[41] Ibid

[42] Ibid at page 85

[43] as is the case with the Iranian RSA.

Petroleum regimes[44]



Kenya has opted for PSAs similar to other developing countries. The Constitution and the PEPA vest all the petroleum resources within mainland Kenya and the continental shelf with the GoK. The government is mandated to exploit the hydrocarbons either via the NOCK or by way of contracting to IOCs. The preference for PSAs by developing countries stems from the perception that the government is in a much stronger position than under a concession to exercise greater control over the resource development process though the reality which has emerged suggests that both the PSA and the concession can be made equivalent both in control and economic rent appropriation.

Investment protection

Prior to investing in developing countries, IOCs seek assurance that the risk of unilateral and arbitrary changes to the law and investment agreements which can dilute the value of their project can be satisfactorily managed. One specific feature of the petroleum industry which heightens political risk is that exploration and development of resources must take place where the resources are.[45] Once the investment has been sunk, host governments may renege on their earlier commitments and toughen the fiscal environment.[46] The recurring variations in petroleum prices can also make an apparently profitable deal under an agreement previously negotiated look unattractive, and this can be a trigger point for government to revise fiscal terms, sometimes to the detriment of the oil companies.

---

[44] Daniel Johnston. International petroleum fiscal systems and production sharing contracts. PennWell Books, 1994 page 53

[45] Bindemann, Kirsten. Production-sharing agreements: an economic analysis. Oxford: Oxford Institute for Energy Studies, 1999 page 4.

[46] Cameron, Peter. "International energy investment law: the pursuit of stability." OUP Catalogue (2010) page 62.

There are three legal techniques which investors seek to mitigate the above discussed political risk or at least limit the resulting economic loss, namely: legislative, contractual and treaty based - all of which are embedded in Kenya's petroleum fiscal regime.[47]

Legislative protection

Legislative support against unilateral revision of petroleum terms is usually by substantive provisions in national legislation setting out guarantees for the protection of a category of investments.[48] The basic criticism of law based protection measures however is *that parliament can undo whatever it enacts*. In its quest to attract FDI to the petroleum and other capital projects, Kenya has passed legislation that reassure investors of protection. The Constitution for example prohibits the government from arbitrarily depriving a person of property or interest over any property except in public interest in which case a prompt and fair compensation must be made.

Treaty based protection

Instruments such as bilateral and multilateral investment treaties are also used to protect investors.[49] Bilateral Investment Treaties (BITs) concluded between capital exporting and importing countries set out substantive principles on investment protection, as well as the procedures of investor state arbitration.[50] The umbrella clause, the Fair and Equitable Treatment (FET) standard and the principle of utmost good faith embedded in BITs ensure the provision of additional protection.

The wording of an umbrella clause in a BIT is broad and can be interpreted as elevating every single contractual obligation entered into by a state to the status of a treaty obligation.[51] Premising on the FET standard, it can be argued that if a stabilisation clause has been included in an agreement, there is the expectation that the law will not be changed or that if changed, a renegotiation will follow to rebalance the fiscal position. Kenya presently has entered into BITs with three countries namely Germany, Italy and Netherland.

---

[47] Ibid

[48] Such provisions would normally be found in the general legislation applicable to energy and to foreign investment, but given the high value of certain energy and natural resource projects and their sensitivity to the host state's economic development, a special legislative instrument may be used. For some reason, the substantive provisions containing stabilisation guarantees may be spread across several forms of legislation: energy, investment, commercial and others.

[49] See supra note 46 at page 65

[50] Ibid page 147

[51] Ibid page 66

Stabilisation clauses

Investors in the petroleum sector are keen to include in their investment agreements stabilisation clauses. These clauses aim at ensuring that future changes in a country's legislation do not vary the terms of the contract as originally concluded.[52] Stabilisation clauses have transformed over time and to date there are four types used in international investment contracts. These include: freezing, prohibition on unilateral change, balancing and allocation of burden, as discussed in detail further below.[53]

Types of stabilisation clauses

Type of stabilization clause	Discussion
Prohibition on unilateral changes[54]	They are also known as intangibility clauses. They ensure that the terms of the investment agreement are neither modified nor abrogated except with the contracting party's mutual consent.
Freezing clauses[55]	The host state is precluded from changing its legislation in relation to the relevant project. Such clauses are criticized as encroaching on a country's sovereign legislative prerogative.
Allocation of burden[56]	These clauses seek to allocate the fiscal and related burdens created by a unilateral change in the law usually to the NOC or the State.
Balancing clauses[57]	These are sometimes called economic stabilization clauses. They provide for automatic adjustments or negotiations to reinstate the initial economic balance of the investment should there be an amendment to legislation with a fiscal impact to the investment.

Kenya has included stabilisation clauses in its MPSA to assure investor protection from political sovereign actions once the investment has been sunk. The stabilisation clauses in Kenya's MPSA take the form of an allocation of burden and intangibility clauses. The share of profit oil taken by the government is assumed to include the contractor's share of corporation tax that would have been paid

---

[52] Sornarajah, Muthucumaraswamy. The international law on foreign investment. Cambridge University Press, 2010. page 7

[53] See supra note 46 at page 67

[54] Ibid at page 74

[55] Ibid at page 70

[56] Ibid at page 80

[57] Ibid

in respect of their profit oil. *Kenya's petroleum agreements are thus commonly referred to as tax paying PSAs.* Similarly, the contract cannot be amended, modified or supplemented except by an instrument in writing signed by the parties.

Farm down of petroleum interests

The petroleum sector extensively uses farm down techniques which involve the assignment of part or all of the petroleum interests to a third party. The third party, called the "farmee", may reimburse the farmor all or part of their sunk exploration costs and also commits to fund certain costs associated with future exploration work as outlined in a work programme. Such transactions raise finances but also manage exploration and development risks in the sector. Countries that place onerous requirements on assignment of petroleum interests can potentially discourage FDI in the sector. Assignments provide the opportunity for big IOCs to collaborate with smaller oil companies that could have already played a key role in de-risking the acreage in place but are constrained by resources and expertise to go it alone that the bigger players possess.

Kenya's MPSA requires that the Minister does not unreasonably withhold consent to any proposed assignment. The MPSA does not however provide for exemption from the application of transfer taxes on the assignment of interest. The following taxes presently apply on the assignment of rights in Kenya.

Tax type	Discussion
Income Tax Act	Net gains arising in relation to the disposal or assignment of a petroleum interest, including information and shares of the petroleum company, are subject to income tax at the corporation tax rates ranging from 30% to 37.5%. Work obligations or future carry are excluded from the proceeds deemed to be earned on the disposal of a petroleum interest.
Value Added Tax	Assignment of rights ordinarily amounts to a supply of services within the meaning of the VAT legislation. Unless specifically exempted from VAT or subject to VAT at the rate of zero percent, assignments of rights are subject to VAT at the rate of 16%. Farm outs are potentially liable to VAT. The VAT legislation presently exempts supplies imported or purchased for direct and exclusive use in oil, gas or mining prospecting or exploration by a licensed company from VAT.

Tax type	Discussion
	We do not consider that farm outs fall within the realm of this exemption.
Stamp duty	Unless exempted, every instrument relating to property situated or to any matter or thing done or to be done, in Kenya, is chargeable with stamp duty.

Royalty payments under the PSAs

Royalties represent a charge that is levied by the resource owner on the extraction of natural resources. Royalties are favoured by the government because they are easy to administer, collect and also provide a first tranche of payment as soon as production commences. Royalties are however unpopular with IOCs and are criticised as insensitive to costs, front end loaded, not being related to project profitability and with the potential to cause production to become uneconomic prematurely. IOCs find royalties palatable only if they are designed in a manner that links them to profitability of the project.

Royalty rates in practice tend to range from zero to 20% but anything above 15% is considered as excessive. Kenya's MPSA does not provide for payment of royalties. This is the preferred position for IOCs though it has the potential to deny government first tranche payments to meet citizenry demands of an overly expectant population which can result in significant political pressure on the ruling government.

Cost recovery under the PSAs

Exploration and development expenses are typically borne by the IOC which forfeits the right to be reimbursed in the event discovery and development fail.[58] An IOC will pay royalties on gross production, if applicable. After deduction of the royalties, the IOC is entitled to a predetermined share of production for their exploration, development and production costs known as cost oil. The remainder of the production dubbed profit oil is then shared between the government and IOC at a pre-specified share.[59]

Cost recovery is an ancient concept based on the principle of 'the one who put up the capital should at least get their investment back."[60] Not all costs incurred by the IOC are cost recoverable and in

---

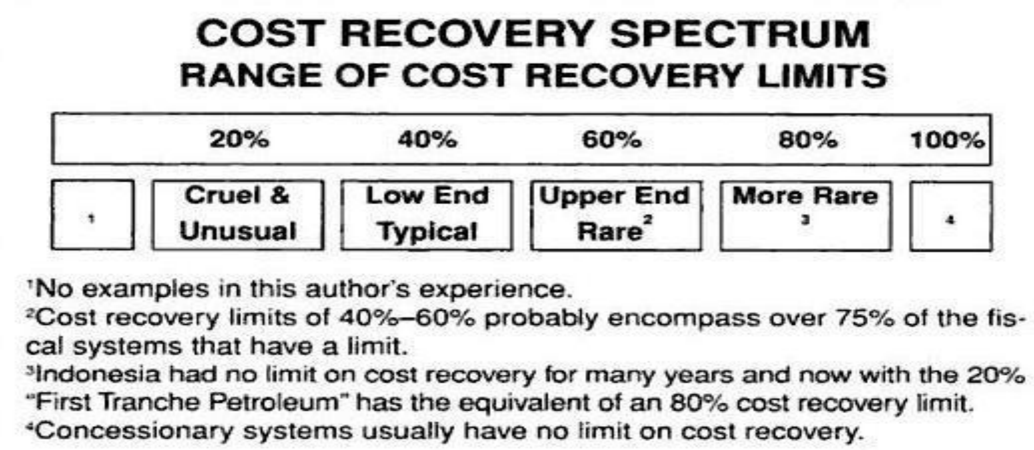
[58] See supra note 2 at page 99

[59] Ibid

[60] Ibid at page 54

some instances the cost oil can be taxable. The commonest costs recoverable include unrecovered costs from previous years. Additional costs include operating costs which, in fact, are the most significant expenses once exploration and development costs have been recovered. Others include written down capital costs, operating costs with the commencement of production, interest on loan though many jurisdictions restrict this, decommissioning costs as - well as annual depreciation, depletion and amortization (DD&A) and investment credits.

Cost recovery spectrums[61]



As illustrated above, countries typically place a limit on the amount of oil that can be taken as cost oil in an accounting year. This allows the government a guaranteed share of profit oil because a certain percentage of production will always come through in the profit oil split. Countries with a cost recovery cap usually permit companies to carry forward in the next period the unrecovered costs which can be utilised then. Cost recovery is also usually ring-fenced around the contract or development area whereby costs associated with a particular block or license can only be recovered from revenues generated from within that block or license. The more generous the cost recovery limit is, the longer time span for the government to realise its take.

Kenya's MPSA sets out costs that a contractor can recover in respect of their petroleum operations consistent with the foregoing discussion. Kenya's MPSA is silent whether there is a cost recovery limit. Information based on an old PSA that was entered into with Amoco in 1989 and in the public domain however reveals that there is an annual cost recovery cap of 50% with the remainder carried forward to the following year until recovered. Cost recovery is additionally ring fenced to the particular PSA and capital expenditure can only be recovered at the rate of 20% per annum.

[61] Daniel Johnston. International petroleum fiscal systems and production sharing contracts. Penn Well Books, 1994 page 62.

Allocation of profit oil under the PSAs

Oil remaining after deducting royalties and cost recovery is referred to as profit oil.[62] Profit oil is split between the IOC and the government, according to the terms of the PSA. While evaluating the competitiveness and attractiveness of the profit oil split, IOCs will review the geological potential of the country and how it balances with the fiscal terms and the cost of doing business. For this reason, governments may not be entirely responsible for determining the appropriate division of profit oil since the IOCs define what the market can bear. The split of profit oil in most countries ranges from just under 15% to 55% for the contractor.

The split of profit oil can be constant or based on a scale linked to cumulative or daily production rates. Some countries have progressive split systems linked to project profitability defined by the rate of return or r- factors. Conventional PSAs are criticised for their inflexibility in the face of ever changing costs and prices. PSAs are ordinarily aimed at sharing production and not profit. To mitigate this shortcoming, some countries develop a family of PSAs adapted to different conditions in the country and these could be based on water depth, geographical location, maturity of basin or field and water depth. However, proliferation of contract types can lead to increased complexity.

Another way of introducing flexibility in the profit oil share is through the use of rate of return (ROR) and r factors, the effect of which is that effective government take increases as the project ROR rises. R- factors connect the split of the profit oil to the investment payback ratio (the r- factor) and this is defined as the ratio of the contractor's cumulative receipts over the cumulative costs including upfront investment. The elements of determining the r- factor vary from country to country. The profit oil spilt is thus premised on the r- factor ratio as is set out in the PSA.

The contractor's share of profit oil is usually, but not always, taxable. In some PSAs, the government pays the contractor's corporation tax from its share of profit oil; these are called taxpaying PSAs. In some countries, the government has the option to purchase a certain portion of the contractors' share of production at a price lower than the market price: a provision known as the domestic market obligation.

Kenya's MPSA provides a schedule for the split of profit oil though the indicative figures are not included therein. It is worthwhile to note that Kenya's PSA is an income tax paying PSA in the sense the income tax payable by the taxpayer is carved out of the profit oil share of the government. Information based on a PSA that was entered into with Amoco in 1989 and in the public domain shows the underlying split of profit oil.[63]

---

[62] See supra at note 2 page 42.

[63] Summary description of 226 fiscal systems. Van Meurs and Associates Limited page 416.

Profit oil split

Production BOPD	Government take	Contractor take
Production> 20000	50%	50%
Production <20000>50000	55%	45%
Production<50,000>100000	68%	32%
Production<100,000>200,000	75%	25%
Production<200,000	80%	20%

Bonus and other payments under the PSAs

Bonuses and annual payments also extract rent from the petroleum industry. Bonuses are paid to the government at various stages in the petroleum cycle. Signature and discovery bonuses are received prior to project development, whereas production bonuses are paid when production commences or reaches certain milestones. Most PSAs include annual fees comprising acreage rentals, as well as training levies. Acreage rentals are payable on the grant of a license and thereafter annually on the anniversary of the grant until the termination of the license.

Bonuses and annual fees are front end loaded. They are also not linked to project profitability. Whilst they provide the government with upfront revenues that are easily collected, they can discourage investment if excessive, especially in marginal fields. Most tax regimes allow for bonuses to be tax deductible since they are a cost of doing business. Bonus payments are usually not allowed for cost recovery under PSA rules though are deductible for income tax purposes.

Kenya’s MPSA does not provide for the payment of bonuses though it envisages the payment of annual fees computed in accordance with the acreage held. These payments are not cost recoverable. Information reviewed based on the 1989 PSA with Amoco shows the following split.

Annual acreage fees

PSA	Initial exploration	First extension	Second extension
Amoco PSA	USD 5 per km	USD 10 per km	USD 20 per km

Government participation

There are strong sentiments in resource rich countries that resource exploitation activities should not be left entirely in the hands of foreigners. For this reason, governments usually co-invest alongside the private investors as a means of asserting greater operational control and direction in the exploitation of petroleum resources. Excessive government participation is however not popular with IOCs for a variety of reasons including the potential of reducing entitlement to the petroleum sharing and unwarranted government sway in technical and working committee meetings. Government participation, however, carries risks. If the government bodies are not efficiently staffed as well as robustly supervised, there is the potential likelihood of slowing project development, decreasing the revenue accruing to the state, as well as potential corruption issues.

Kenya's MPSA gives the government leeway to elect to participate in petroleum projects from the development stage though the interest that the government can acquire is not set out. Where the government elects to participate in the development of a discovery, the MPSA obliges it to pay its share of contract expenses. The government is thus carried through exploration until development.

Local content in the PSAs

Local content is the value added brought to a host nation including its regional and local areas through the activities of the petroleum industry. This could be realised through work force development via employment and capacity building of local workforce, developing supplies and services locally, as well as procuring supplies and services locally.

Strategies devised by countries to achieve local content include simple contractual requirements that favour the use of local goods and services, imposition of training obligations, and preferential regulation and taxation of local companies over foreign. Contractual or legal provisions may prescribe that technology transfer is included in the bidding parameters and the criteria for the acquisition of petroleum rights. Incentives may similarly be provided to foreign investors who re-invest their profits domestically as a strategy of anchoring local content.

Kenya's local content requirements presently derive from the contractual arrangements set out in the PSAs. There has not been any legislation enacted to enforce these. Kenya MPSA requires contractors and their subcontractors to employ Kenyan citizens as well as providing them with the necessary experience and expertise through the course of their contract.

Fiscal terms under the Income Tax Act

Kenya's income tax impositions on oil and gas operations do not materially differ from the income tax regime applicable to other business operations but there are some modifications to take into account the peculiar features of the upstream oil and gas industry.

Income Tax terms

Issue	Discussion
Tax paying PSA	Kenya has a tax paying PSA. This means that the share of profit oil received by the IOC is net of income taxes payable by the contractor, which is carved out of government's share of production. This position is re-affirmed by the ITA. The wording of tax paying provisions in the PSA is important as it may have a bearing on the ability of the contractor to claim a foreign tax credit in the country of the parent company.
Taxation of gain on farm out transactions	As explained above in the section relating to farm outs, gains arising therefrom are subject to income tax. The ITA introduces a controversial twist which may be a subject of future dispute. The MPSA provides that the government's share of profit oil shall be inclusive of all taxes based on income or profits specifically payable under the ITA. The ITA on the other hand excludes the income tax payable on gains on farm outs from the scope of income tax envisaged under the MPSA, which may be contested.
Ring-fencing of blocks	The provisions of the ITA are aligned with the Kenyan MPSA with respect to ring-fencing of blocks. Expenditure incurred by a contractor in a license area can only be offset against income derived from the same license area. The same applies to tax losses incurred in the license area which can be carried forward indefinitely until utilized against income derived from the same license area.

Issue	Discussion
Lifecycle of petroleum projects	Tax capital allowances envisaged by the ITA are cognisant of the lifecycle stage of petroleum projects. All costs incurred at exploration stage are tax deductible in the year they are incurred. Capital costs incurred during development phase are tax depreciated at an annual rate of 20% but there are no special provisions presently applicable to production operations.
Withholding taxes	IOCs are obliged to withhold tax on the following payments and the rates set out made to non-resident persons. a. Dividends – 10% b. Interest – 15% c. Royalties or natural resource income – 20% d. Management or professional fees – 12.5%
Taxation of petroleum service companies	Service fees paid to non-residents subcontractors for services provided to contractors are liable to withholding tax at the rate of 5.625%. However, this does not apply where the non-resident person has a permanent establishment (PE) in Kenya, in which case the PE is liable to corporation tax at the non-resident rate of 37.5%. It is not explicitly set out in the law whether reimbursements, mobilisation fees and disbursements should be excluded from the base amount of the service fees to which withholding tax applies.
Taxation of natural resource income	Similar to Uganda and Tanzania, Kenya taxes natural resource income. Natural resource payments now attract withholding tax at the rate of 5% if made to resident persons and 20% if paid to non-resident persons. The Finance Act defines natural resource income to mean *“any amount including a premium or such other like amount*

Issue	Discussion
	paid as consideration for the right to take minerals or non-living resources from land or sea or an amount calculated in whole or part by reference to the quantity or value of minerals or living or non-living resource taken from land or sea." Some of the transactions that fall within the realm of natural resource income include, among others, overriding royalties and production payments which are popular techniques for financing the development of oil and gas operations.

Fiscal terms under the Value Added Tax Act

Ordinarily, petroleum companies are unable to register for VAT until the production stage or when they make sales of qualifying business assets falling within the registration thresholds. The lead time between exploration, development and production is very long. The inability to register for VAT purposes means the oil companies must suffer as a cost all the VAT incurred on expenses for their petroleum operations.

Under Kenya's VAT legislation, inputs excluding motor vehicles imported or purchased for direct use in oil and gas exploration by a licensed oil and gas company are exempt from VAT. While this exemption is laudable, it does not extend to the development stage where significant financial resources shall be spent.

Fiscal terms under the EACCMA, 2004

Kenya is part of the East African Community Customs Union and thus uses the same legislation applicable to all the East African countries namely Uganda, Tanzania, Rwanda and Burundi with respect to customs matters. The EACCMA, 2004 exempts all machinery and inputs imported by licensed oil and gas companies and their subcontractors for direct and exclusive use in oil and gas exploration and development from import duty. This tax policy stance taken by Kenya is laudable and consistent with the position adopted by many other countries that exempt extractive projects from import duties.

Railway Development Levy

The Finance Act 2013 introduced a levy known as the Railway Development Levy paid on all goods imported into Kenya. The levy is at the rate of 1.5% of the customs value of goods and is payable at the time goods are imported. The wording of the law implies that this levy only applies to good imported permanently and not temporarily.

Petroleum companies engaging in upstream operations are not exempted from this levy which has the potential to adversely affect the project economics of petroleum projects.

5 Conclusion

IOCs are keen to carry on business in areas where they can project a reasonable chance of finding petroleum. They also prefer dealing with stable governments that provide for contract terms that assure a return on investment that is commensurate with the risks undertaken in investing in the country's petroleum sector. IOCs are very much interested in booking oil barrels in their financial statements. Financial analysts tend to measure company value and also approximate future success of the company based on its ability to replace production. A company that books more hydrocarbon barrels will have a higher reserve- replacement ratio which will count towards its financial prosperity as measured by investment analysts. The ability to book hydrocarbon reserves by a company depends on the petroleum fiscal regime in place.

Kenya petroleum fiscal regime treads the intricate and complex path of converging government objectives with the IOCs. Hydrocarbon discoveries heighten population expectations of immediate economic prosperity which usually is not the case. Because of this pressure, governments are tempted to take an exceedingly short term view of maximising revenue collection from natural resource projects. They may enforce high and unsuitable taxes which may affect investment to the petroleum sector. The petroleum fiscal terms adopted by Kenya are mindful of the global competition for FDI in the petroleum sector and largely reflect incentives and conditions that are aimed at attracting FDI to the sector. To the greatest extent, the petroleum fiscal terms adopted by Kenya are favourable for FDI.The only drawback with the fiscal regime which has the potential to derail the momentum building is the unclear tax policy position on farm down transactions. Not all farm down transactions generate windfall profits as some pundits presently appear to opine. Farm down transactions represent a real opportunity for big oil companies to acquire working interest in the country's petroleum sector originally dominated by smaller oil companies. The smaller companies de-risk the geological circumstances of the country thus enabling big IOCs convince their shareholders to invest in emerging petroleum countries sectors.

6 Bibliography

Text books

1. Angulo, Albert W. Financing the international petroleum industry. Graham & Trotman, Limited, 1978.
2. Baunsgaard, Thomas. A primer on mineral taxation. International Monetary Fund, 2001.
3. Bindemann, Kirsten. Production-sharing agreements: an economic analysis. Oxford: Oxford Institute for Energy Studies, 1999
4. Cameron, Peter. "International energy investment law: the pursuit of stability." OUP Catalogue (2010).
5. Duval, Claude, and H. de Leuch. International petroleum exploration and exploitation agreements: legal, economic and policy aspects. Barrows, 1986.
6. Daniel Johnston. International petroleum fiscal systems and production sharing contracts. Penn Well Books, 1994.
7. Daniel, Philip, Michael Keen, and Charles McPherson, Eds. The taxation of petroleum and minerals: principles, problems and practice. Routledge, 2010.
8. Garnaut, Ross, and Anthony Clunies-Ross. "Taxation of mineral rents." OUP Catalogue (1983).
9. Johnston, Daniel. International exploration economics, risk, and contract analysis. Penn Well Books, 2003
10. Nakhle, Carole. Petroleum taxation: sharing the oil wealth: a study of petroleum taxation yesterday, today and tomorrow. Routledge, 2008.
11. Shah, Anwar. "Fiscal incentives for investment and innovation." Available at SSRN 896144 (2006).
12. Sauvant, Karl P., ed. Yearbook on International Investment Law & Policy 2010-2011. Oxford University Press, 2012.
13. Sornarajah, Muthucumaraswamy. The international law on foreign investment. Cambridge University Press, 2010.
14. Weigel, Dale R., et al. Foreign direct investment. International Finance Corporation, Foreign Investment Advisory Service, 1997.
15. Summary description of 226 fiscal systems. Van Meurs and Associates Limited. (Uncited)

Legislation

1. The Constitution of Kenya, 2010
2. Kenya's Petroleum (Exploration and Production) Act Cap 308
3. Kenya's Petroleum (Exploration and Production) Regulations
4. Kenya's Model Production Sharing Agreement
5. The East African Community Customs Management Act, 2004
6. The Maritime Zones Act Cap 371
7. Kenya's Bilateral Investment Treaties
8. Kenya's Investment Promotion Act Cap 485B
9. Kenya's Export Processing Zones Act Cap 517
10. Kenya's Income Tax Act
11. Kenya's Value Added Tax Act

Internet sources

1. http://www.cairnenergy.com/index.asp?pageid=324> accessed on 27th July 2014.

Contacts

For more information about this publication, please contact:

Nikhil Hira
+254204230377
nhira@deloitte.co.ke

Michael Sturdivant
+255222116006
msturdivant@deloitte.co.tz

Fred Omondi
+254204230377
fomondi@deloitte.co.ke

Denis Kakembo
+254204230377
dekakembo@deloitte.co.ke