# Kenya

Kaplan & Stratton

## Introduction

Interest in the Kenyan upstream oil and gas sector has developed significantly following discoveries of oil in Uganda and recent gas discoveries offshore East Africa. This interest intensified following Tullow Oil's announcement on 26 March 2012 that it and its partners Africa Oil and Centric Energy had discovered oil in Kenya in the Tertiary Rift Basin.

There are four principal exploration basins in Kenya: the Lamu Basin, the Anza Basin, the Mandera Basin and the Tertiary Rift Basin. In addition to the five Production Sharing Contracts (PSCs) that the Kenyan government has entered into with Tullow and its partners for exploration in the Tertiary Rift Basin, the government has also entered into PSCs under which exploration is taking place in the Lamu and Anza Basins. There has been a good deal of transactional activity surrounding these PSCs in the course of 2012, with a number of new players seeking participation.

## Key legislation and regulatory structure

Key legislation relating to the upstream sector includes the Constitution of Kenya, the Petroleum (Exploration and Production) Act, chapter 308 of the Laws of Kenya (the Petroleum Act), regulations made under the Petroleum Act and the Ninth Schedule to the Income Tax Act, chapter 470 of the Laws of Kenya.

The key institutions involved in regulating the oil and gas sector are currently the Ministry of Energy and the National Oil Corporation of Kenya Limited (NOCK). There is no separate industry regulator. The 2010 Constitution provides for the establishment of the National Land Commission (NLC) and for ratification of grants of rights or concessions regarding the exploitation of natural resources by parliament. The NLC is currently in the process of being constituted under the National Land Commission Act, which came into force in May 2012.

The Petroleum Act states that all petroleum is vested in the government. This is consistent with the 2010 Constitution, which states that all minerals and mineral oils shall vest in the national government in trust for the people of Kenya. However, under the Constitution, the administration of minerals and mineral oils is to be vested in the NLC. It is not clear how this will affect the powers of the Minister of Energy under the Petroleum Act. It is anticipated that the Minister's powers will fall away. At present, these powers are set out in the Petroleum Act. They comprise the power to enter into petroleum agreements and petroleum exploration agreements on behalf of the government and to make ancillary regulations.

NOCK is wholly owned by the Kenyan government. The company acts as an instrument of government policy in matters related to oil and gas and gives advice to Kenyan energy policymakers. NOCK was established to facilitate and participate in the exploration for petroleum products. It also acts as the agent of the government in relation to the compilation of national energy data, running petroleum laboratories and the development of alternative fuels. Initially, NOCK's activities consisted primarily of exploration activities delegated from the Ministry of Energy. In the recent past, it has sought to engage in downstream activities by importing crude oil into the country. This is intended to provide stability in the markets by commercial importation, distribution, sales and exportation of energy products. In 2010, NOCK was awarded a 30 per cent quota for the importation of crude oil, jet fuel and gasoil but, at the time of writing, is not importing its allocation.

Under the 2010 Constitution, the grant of a right or concession by or on behalf of any person, including the national government, to another person for the exploitation of any natural resource of Kenya is subject to ratification by parliament. Under transitional provisions, this requirement does not come into effect until parliament passes further legislation providing for the classes of transactions that are subject to ratification. Under the Constitution, this further legislation must be enacted within five years of the effective date of the new Constitution – ie by 28 August 2015. It is currently not known what impact this may have on the future grant of rights under the Petroleum Act. The provisions of the new Constitution apply only to future transactions; existing contracts should not be affected. It is anticipated that ratification will not give a PSC the force of law, but be procedural step necessary to ensure the PSC's validity.

## Licensing regime

Under the Petroleum Act, the Minister of Energy has the power to divide Kenya and its continental shelf into blocs. No person may engage in any petroleum operations without the Minister's permission. The Petroleum Act permits the government to conduct petroleum operations either through an oil company established by the government for that purpose (ie NOCK) or through private contractors that are licensed by the government (acting through the Minister of Energy) under petroleum agreements.

A model form petroleum agreement is scheduled to regulations made under the Petroleum Act and is a form of production sharing contract (the Model Form PSC). The Petroleum Act sets out certain obligations to the contractor that are implied into any PSC but that are, in any event, dealt with in more detail in the Model Form PSC.

The Ministry of Energy administers the application process relating to the entry into a PSC. This can be by way of competitive bidding process or through bilateral negotiations. The minister may require evidence of the financial and technical qualifications of any applicant. The Model Form PSC forms the basis for negotiations. As at the time of writing, there have been no bidding rounds.

Under the Petroleum Act and Regulations made thereunder, the minister may also grant non-exclusive exploration permits to carry out geological and geophysical surveys in respect of any open block. The minister may grant more than one exploration permit for any block.

No entity other than a Kenyan incorporated or registered company may enter into a petroleum agreement with the government.

Neither the Petroleum Act nor the Model Form PSC prescribe the length of any exploration period, which is therefore a negotiable term, although typically the period would be two or three years. The initial exploration period can be extended by two further periods, the first for two years and the second extension for a period that is negotiable. Following approval of a development plan for any commercial discovery, the Model Form PSC continues for 25 years from the date of such approval.

## National oil company/state participation

Article 28(1) of the Model Form PSC provides for the government to have a carried 'Participation Interest' during the exploration phase, the percentage interest to be agreed. The government may elect to participate in a development area within six months of the date a development plan is adopted. The percentage participating interest is, again, to be agreed and may be equivalent to the initial carried interest or also comprise an additional interest. The government may participate directly or through an appointee. The government will bear its share of the costs in respect of development area from the date of its participation.

## Fiscal regime

Under the terms of the Model Form PSC:

- the contractor is entitled to recover petroleum costs out of specified percentage of crude oil produced from the contract area in a fiscal year. The percentage of production available for cost recovery is a negotiable term. Capital expenditure is recoverable at a rate of 20 per cent per annum. Costs unrecovered in any fiscal year can be carried forward;
- total crude oil production not used in petroleum operations less cost oil is profit oil and is split between the government and the contractor on a sliding scale depending on daily production figures. The percentage split is a negotiable term;
- if the price of crude oil for any quarter exceeds a threshold price (in the model PSC being $50/bbl FOB Mombasa, escalated by reference to changes in the US Consumer Price Index since November 2007) then a 'Second Tier Amount' is payable to the government calculated as 26 per cent of the contractor's share of profit oil for the relevant quarter multiplied by the value received in that quarter less the threshold price;
- the contractor is obliged to comply with the requirement of applicable income tax laws that, in the case of upstream activities carried out under a PSC, are set out in detail in the Ninth Schedule to the Income Tax Act. The basic rate of tax is 30 per cent. The Ninth Schedule contains detailed provisions governing capital allowances and deductions. There are additional provisions governing the recoverability of expenses from cost oil (as defined) under the Model Form PSC (Article 26). The government's share of profit oil includes all taxes payable on income or profits by the contractor under the Income Tax Act and dividend tax imposed by Kenya on any distribution of income or profits by the contractor;
- the contractor will be required to pay a signature bonus and surface fees (Article 5). The signature bonus is a one-time payment, although its payment may be spread over the life of the contract. Surface fees are payable on an annual basis per square kilometre of the relevant block during exploration and production;

- under the Petroleum Act, a training levy is payable at the rate specified in the relevant PSC. The rate is a negotiable item. The PSC usually provides for a training programme to be established in consultation with the Minister and requires the contractor to contribute or hold to the order of the Minister a specified minimum annual amount as the training levy;
- the contractor may export petroleum without restriction and free of taxes, charges, fees, duties or levies of any kind; and
- the importation by the contractor of materials, equipment and supplies shall be exempt from all customs duties.

## Local content requirements

Under the Petroleum Act, a PSC has an implied term that the contractor will give preference to the employment and training of Kenyan nationals in petroleum operations and give preference to the use of products, equipment and services locally available. This is reflected by an express requirement in the Model Form PSC that contractors and sub-contractors are required to give preference to Kenyan materials, supplies and services for use in petroleum operations as long as their prices, quantities and timeliness of delivery are comparable with the prices, quality, quantities and timeliness of delivery of non-Kenyan materials and supplies and a requirement to employ and train nationals. A training programme is to be agreed with the minister.

## Domestic supply obligation

Under the Model Form PSC, a contractor may be required to supply crude oil to the government for domestic consumption. The maximum amount that a contractor may be required to supply is the difference between the amount of the government's share of crude oil from the contract area less the amount of the domestic supply required multiplied by a fraction, the numerator of which is average crude oil production from the contract area and the denominator of which is total crude oil production in Kenya.

The price paid by the government shall be a weighted average price per unit price paid for arm's-length sales from the contract area during a calendar quarter or, if no such sales, an average price paid for arm's-length sales for export for crude produced in Kenya and in major crude oil producing countries, adjusted for grade, gravity and quality and otherwise as necessary.

## Transfer of interests

The consent of the Minister of Energy is required for the assignment by the contractor of all or part of its rights and obligations under the Model Form PSC to a third party. The Minister of Energy is required to grant or refuse consent to the proposed assignment within 30 days of receipt of a notice from the contractor that it intends to make an assignment and may not be unreasonably withheld. The minister may require the proposed transferee to provide a performance guarantee.

Under the terms of the Model Form PSC, the consent of the Minister of Energy is not required to an intra-group transfer if the transfer results in the transferor and the transferee retaining joint and several liability for the obligations of the transferor under the PSC.

The terms of the Model Form PSC require the contractor to report any material change in corporate structure, ownership and financial position of the contractor and its parent company, but no consent is required from the Minister of Energy on a change of control. However, disposal of a majority interest in a PSC or a direct or indirect change in control of the contractor will require the approval of the Competition Authority of Kenya under the Competition Act 2010. Although it is expected that regulations under the Act will be published, there are currently no thresholds.

The government introduced amendments to the Income Tax Act under the Finance Bill 2012, under which oil companies, mining companies and mining prospecting companies will be subject to a 10 per cent capital gains tax on the disposal of shares and assets. The Bill does not define 'oil companies' but it is expected that the new tax will apply (at a minimum) to all upstream operators. At the time of writing, it is uncertain when the Finance Bill will be enacted.

Under the changes introduced by the Finance Bill, a disposal of a right under a PSC would now give rise to a taxable chargeable gain. It is not clear how the new provisions will interact with the Ninth Schedule to the Income Tax Act, under which the consideration received on a disposal of an interest under a PSC is treated as income by the disposing company and is subject to tax accordingly. It is also not clear how the new provisions relate to the general position under the Model Form PSC that all tax on income and profits is part of the government's share of profit oil.

Kenyan companies may also be liable to compensating tax on the distribution of capital gains tax. Compensating tax is a penalty tax payable if dividends are paid out of reserves that have not borne income tax at the corporate rate. It is intended to prevent companies that may have been entitled to certain tax incentives using their tax holiday to distribute dividends to their shareholders, rather than reinvesting the profits in the business. It may arise if, for example, a Kenyan holding company sold the share of the Kenyan entity that has an interest in the PSC. The proceeds would not be income in the hands of the selling entity and therefore not subject to tax. However, any distribution would be caught by the compensating tax regime. As with income tax, it is not clear how the new provisions of the Finance Bill will, if enacted, interact with the compensating tax provisions.

## Stabilisation/equilibrium and dispute resolution

The Model Form PSC states that 'if after the effective date of this contract the economic benefits of a party are substantially affected by the promulgation of new laws and regulations, or of any amendments to the applicable laws and regulations of Kenya, the parties shall agree to make the necessary adjustments to the relevant provisions of this contract, observing the principle of mutual economic benefits of the parties'.

The Model Form PSC provides for disputes that cannot be settled amicably to be determined by arbitration under the UNCITRAL Rules; such arbitration to be held in Nairobi, Kenya.

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