Petroleum Contracts and Taxation: is East Africa Prepared?
by T. Njoroge Daniel

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Executive Summary

The challenges that are faced by gas and oil exploration and production companies in Africa are enormous, ranging from gang extortion in local communities to government regulation and taxation. The East African region (Kenya, Uganda and Tanzania) have not been traditional producers of oil and gas. However, with the recent developments in the discovery of oil and gas deposits and commercial extraction slated in the near future, these countries need to be preparing for changing manpower requirements, fiscal policies and new regulations to exploit the benefits brought about by oil and gas production. At the same time the governments must seek to prevent the oil curse from afflicting the region. The governments in the region have been at the forefront in awards of contracts and improving the oil and gas policy and legislation. It is therefore important for these three countries to learn from countries with efficient regulatory and taxation policies to fossil fuel development in the energy exploration and production sector. The model countries discussed herein include Trinidad and Tobago, Indonesia and Norway. These countries provide learning points that can be used in developing fiscal policy conducive for oil and gas exploration and production.
Introduction

The challenges that are faced by gas and oil exploration and production companies in Africa are enormous, ranging from gang extortion in local communities to government regulation and taxation.¹ This makes it crucial for any company in the oil and gas sector to have long-range and strategic planning to counter the various risks encountered in the sector. The major challenges faced by gas and oil companies that are linked to regulation and taxation include delay in passing important laws and legislation and having segmented and uncoordinated tax regimes.² These challenges deter investment and growth in the oil and gas sector.

The East African region (Kenya, Uganda and Tanzania) have not been traditional producers of oil and gas. However, with the recent developments in the discovery of oil and gas deposits and commercial extraction slated in the near future, these countries need to be preparing for changing manpower requirements, fiscal policies and new regulations to exploit the benefits brought about by oil and gas production. At the same time the governments must seek to prevent the oil curse from afflicting the region.³ Most oil and gas companies in the region would like a relaxation of taxation and regulatory policies in the sector. However, governments of the three countries are making the localization regulations more stringent. Moreover, this tension is prevalent world-wide.

Africa has 132 billion barrels of proven oil reserves and 513 Tcf of natural gas reserves. Most of these reserves are in Nigeria, Egypt, Algeria, Libya and Angola.⁴ East Africa should learn from the challenges that have faced these oil producing countries in Africa regarding regulation and revenue sharing. They must devise effective fiscal policies and structures to ensure efficient revenue sharing and regulation of the sector.

The key explorationists in Uganda oil and gas sector are Tullow Oil plc, Neptune, Total SA, China National Offshore Oil Corporation (CNOOC) and Heritage Oil. There has been successful exploration in the country by the above mentioned corporations but there have also been failed exploration projects. In total, 80 wells have been drilled with 20 showing signs of commercially viable extraction. The unsuccessful attempts resulted in the divestiture of Tower Resources in 2013 and Dominion Petroleum back in 2012.

**Petroleum Contracts in East Africa**

The governments in the East African region have been at the forefront in awards of contracts for the commercial exploitation of the discovered oil and gas deposits. Uganda has a proven capacity of 0.5 trillion cubic feet (Tcf) of gas and 2500 million barrels of oil. In Uganda, the government successfully completed the production sharing agreement (PSA) in 2012 which resulted to Tullow Oil selling some of its stake to CNOOC and Total SA at a cost of $2.9 billion. Further, the government of Uganda oversaw the receipt of 14 pipeline bids for the 352 kilometres reversible flow heated oil product pipeline between Kampala and Eldoret in Kenya. This pipeline is aimed at ensuring smooth transportation of Uganda’s waxy crude oil from the production depots in Uganda to Eldoret, Kenya for further distribution. The government of Uganda further received bids in 2014 for the building of 120,000 barrels per day refinery. This was after the passing of the Petroleum Refining, Conversion, Transmission and Midstream Storage Bill. Uganda plans to start production in 2017 with a production capacity of 20,000 barrels per day (bbl/d) which will be scaled to 60,000 bbl/d and later to 120,000 bbl/d.

In Kenya, the first commercial oil was found in 2013. This followed acceptance of bids to build the 352 km pipeline. The major companies leading in the oil and gas sector in Kenya are Tullow Oil, Anadarko, Total, Apache, Cove Energy, CNOOC, Camac, BG Group, and African Oil. Anadarko was the company to acquire the first offshore oil blocks in 2009. The other exploration and production companies followed later on with

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6 Deloitte *Kenya’s petroleum fiscal regime: Expansive coverage* 2014) 8.
7 Ibid 12.
various developments in the oil and gas sector. The government of Kenya gazetted 8 new deep water oil blocks in 2012. The notable developments include the spudding of the first offshore well by Apache in 2012 with 52 million cubic feet of gas discovered. In 2013, Tullow Oil found and completed a 2,812 bbl/d well which could rise to 5,200 bbl/d in its onshore Twiga South-1 well. Further in 2013, the government of Kenya accepted 14 bids for the building of the 352 km crude oil pipeline from Kampala to Eldoret. This contract was on a build-own-operate-transfer 20 years agreement. In February 2013, the government of Kenya licensed 6 blocks.

In Tanzania, the exploration of oil and gas started in 2010 when international companies set base in the country. Currently, the countries involved in exploration include Ophir Energy, ExxonMobil, Heritage Rukwa, Shell, Statoil, BG Group, Maurel & Prom, Pan African Energy, Petrobras and Ndovu Resources. Notably, the BG group has offshore Blocks 1, 3 and 4, with 7 Tcf of estimated natural gas reserve. Further, ExxonMobil and Statoil’s Block 2 has 13 Tcf of estimated natural gas reserves. Though most of the wells are expected to be commercially viable by 2020, the government of Tanzania has issued various contracts on exploration and scoping of LNG and a crude oil export terminal. Tanzanian Petroleum Development Corporation (TPDC) has entered into agreements with various exploration and production companies through competitive bidding. The latest round of competitive licensing was in May 2014 which resulted in the government licensing 9 offshore and onshore blocks.8

**Taxation and Regulation in the Petroleum Sector**

The countries in the East African region have not been traditional producers of oil and gas and they are just being introduced to the league. Commercial production is yet to start in the three East African countries, though it is slated in the near future. Moreover, there have been marked improvements in the oil and gas policy making and legislation development.9 However, laws and fiscal policy governing the oil and gas sector in the region are at infancy.

The successful exploration of oil and gas in the East African region provides key opportunities for growth and development of the region. There are many new exploration blocks that have been opened and others still to be floated for competitive bidding. This will provide a new platform for oil prospecting and producing firms and also the governments to generate revenue. Further, the revenue generation of the governments in the East African region will improve since there will be improvement in port management and development to cater for exports of oil and gas. Further developments are expected in pipeline construction and engineering, oil and gas plant construction and engineering, gas-powered electricity generation, upgrade of existing refineries and development of new ones. These developments are expected to enhance the tax base of the region thus bring more revenue for economic advancement to the three nations.

Moreover, to take advantage of these opportunities the regulatory authorities and policy makers in the three East African countries need to deal with the challenges that have been experienced earlier in the oil and gas sectors in Africa.\(^\text{10}\) The biggest challenges have been regulatory compliance, corruption and tax disputes. In Uganda, the various contractual agreements in the oil and gas sector have been marred with allegations of corruption, disputes on taxation, delays in infrastructure development and delays in passing laws to guide the oil and gas sector.\(^\text{11}\) There have also been allegations of government interference in contractual agreements where the government of Uganda has defended its involvement as being important to ensure equitable distribution of oil and gas revenues. However, these delays, disputes and government interference have only resulted in delays in attaining Uganda’s potential as an oil and gas producer.

In Kenya, the National Oil Company of Kenya (NOCK) is the negotiating arm of the government in oil and gas contracts. The regulations in place require the oil and gas exploration and production companies to surrender 25% of their offshore and onshore blocks to the government after three years. Taxation issues (income tax, Value Added


Tax (VAT), royalties, and administrative requirements) in the oil and gas sector are governed by the Ninth Schedule of the Income Tax Act.\textsuperscript{12} The regulation in the energy sector is in its infancy and the government is in the process of drafting new energy legislation.\textsuperscript{13} Moreover, the Ninth Schedule of the Income tax Act is due to be revised to cater for the changed circumstances and development in the energy sector. The government of Kenya is in the process of drafting the oil and gas policy document which will inform the amendments in the East Africa Community Customs Management Act (EACCMA), income tax, and the VAT Act. The provisions in all these acts will directly affect transactions by the oil and gas exploration and production companies. However, this formulation of legislation and policy is complicated by the increased participation of government. This new focus is to be in localization of the industry, increasing revenues for the government and partial nationalization of petroleum resources. Taxation and regulation of the oil and gas sector faces challenges due to the fragmented rules contained in the various tax legislations and the production sharing contracts (PSCs). There is therefore need to harmonize the tax legislation and the PSCs. Though the standard PSC applied in Kenya establishes how income tax will be imposed on a contractor, it does not stipulate rules for calculating the implied gross-up or what would happen when a form has many production sharing agreements. This is an area that requires clarification by amendments or a newly developed policy.

There is also uncertainty in the regulatory and fiscal policies of Tanzania relating to the oil and gas sector. The country is in the process of drafting new regulations that will govern administration and revenue sharing issues in the sector. However, the drafting of the new regulatory framework is muted due to the immense negotiations required by the government. The government has indicated that massive changes in the energy policy are expected in 2015 and 2016. This has brought uncertainty to the future of regulation and taxation in the petroleum sector. The regulatory and taxation risks in Tanzania are further compounded by the fact that PSCs currently override the law. Further, there are separate

\textsuperscript{12} Income Tax Act Cap. 470
\textsuperscript{13} Miriam W. Oiro Omolo, Germano Mwabu Primer to the Emerging Extractive sector in Kenya: Resource bliss, Dilemma or Curse (2014) Institute of economic affairs 74.
PSCs for natural gas and oil. This multiplicity of regulatory and tax regimes is expected to increase uncertainty in the sector. The exploration and production companies in Tanzania have called for the harmonization of the PSCs and the fiscal policies to make it less burdensome and less expensive for the companies to comply. The companies have also called upon the government to speed up the drafting of the legislation and to consult them in doing so.

There have been populist political statements that have called for increased taxation and nationalization of Tanzania’s natural resources. This has come because of the political campaigns preceding the elections slated to be held in October 2015. This, coupled with the pending regulations, has brought enormous uncertainty to the exploration and production companies. The National Gas Policy Act (NGPA) and the Model Production Sharing Agreement (MPSA) were introduced in 2013 but have not been passed yet. This has further hampered the development in the sector and is expected to delay commercial production of oil and gas further.

The situation in East Africa holds both opportunities and challenges. The regulation and fiscal policies in the energy exploration and production sector are in infancy in the three East African countries. There is opportunity as the oil and gas exploration and production capacities of the three countries are expected to increase the revenue to the governments. This will then be channeled to development projects thus lessening the reliance of the three countries on debt to finance development projects. However, this can only be achieved if the development and administration in the energy sector is efficient and devoid of corruption and fraud in contract awards and taxation issues. It is therefore important for these three countries to learn from countries with efficient regulatory and taxation policies to fossil fuel development in the energy exploration and production sector.

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Lessons that can be learnt from Other Oil Producing Economies

Lessons from Indonesia

One country that the East African nations can learn from is Indonesia. Pongsiri studied the partnerships in oil and gas production-sharing contracts in Indonesia.\textsuperscript{15} His study revealed that the results were remarkably good during the first ten years after 1966. Exploration and development funds were pouring in and Indonesia was the favourite place to invest the corporate dollar. The government was in favour because it had control by virtue of the approval requirement. International oil companies were in favour of the partnerships due to eligibility to access a guaranteed share of the oil (or gas) under a reasonable level of control in the field. Other countries, most notably Indonesia's neighbour Malaysia, copied Indonesia's PSC system which, by the mid-1970s, had become the leading legal framework for cooperation between foreign investors and developing countries. Evidence from Indonesia indicates that the PSC, by its nature, implied the existence of a protected state company and opened up ways for governments in developing countries to focus on the value of petroleum production and the extraction costs, rather than improving financial stability and economic development. The role of government was only in formulation of fiscal policy and regulation. This model emphasizes energies and skills of extracting profits through managing politics and bureaucratic control over oil extraction on ideological grounds, such as sovereignty and nationalism.\textsuperscript{16} Perhaps the right way for developing countries, like those in the East African region, is to expose national oil and gas businesses as early as possible to competition and meanwhile introduce as much objectivity and transparency as possible. This could maximize accountability of the inevitable decision making that must be left with the state such as licensing, tax collection, and rule and regulation implementation for public interest issues, e.g. safety and the environment.\textsuperscript{17} This is in fact the real challenge for policy makers in developing countries.

\textsuperscript{17} Mohammed Amin Adam Fiscal Policy Options for Managing an Oil Economy (2014) Freidrich Elbert Stuftung 2.
Lessons from Trinidad and Tobago

Another fiscal regime that the East African countries can learn from in developing their regulatory and fiscal policies is Trinidad and Tobago. The industrialization policy of the country was based in large part on attracting FDI. A fiscal regime that achieves this objective must be balanced given that the economy's fortune hinges on the collection of rents (taxes) from the exploitation of natural resources. The Petroleum Act\(^\text{18}\) governed the oil and natural gas industry in the country. In exploration and production licenses and concessions were awarded using a tax system modeled after developed countries. In the early years of the industry, the tax models were considered successful. Trinidad and Tobago’s regime was generally considered competitive. In order to further stimulate exploration and production, standard PSCs were introduced in 1974. Under the PSCs the government was not just a regulator but also a partner, and one with a right to access oil and gas for its own marketing. Interestingly, the government never took the lead in marketing its share of PSC hydrocarbons, instead relying on private contractors for monetizing production. This contrasts to the more active involvement in the marketing functions adopted by the governments in the East African region. Indirectly, however, the Trinidad and Tobago government played an important role through its investments in processing plants to manufacture exportable derivatives from oil and gas. Further, the PSC's in Trinidad and Tobago were particularly onerous on slow development or idle blocks, thereby forcing contractors to adhere to rigorous work programmes. The net effect of this shift initiated in the 1970s was a significant increase in E&P activity with the signing of 13 PSCs in just two years. This led not only to additional reserves but also to new producers and greater competition. The significant increases in FDI and hydrocarbon production witnessed since the mid-1990s was due in part to this measure. This in effect led to an increase in rents collected by the government. Another important tool was the Fiscal Incentives Act\(^\text{19}\) enacted in 1979 to attract additional capital investment to the oil and gas sector. The Fiscal Incentives Act provided total or partial relief from corporate tax and customs duty on imported plant equipment and raw materials from countries outside of the Caribbean. Incentives afforded to capital

\(^{18}\) The Petroleum Act Chapter 62:01, Act 46 of 1969 of the Laws of Trinidad and Tobago.

\(^{19}\) Fiscal Incentives Act Chapter 85:01, Act 22 of the Laws of Trinidad and Tobago
intensive, export-oriented industries, had a ripple effect on the growth of the industry. For instance, the LNG industry was initiated in 1999 with the aid of a ten-year tax holiday on the first production infrastructure set-up. The early success of the project and its stable long-term financial footing contributed to three additional production infrastructures in mid-2000s which did not need tax holidays for their investment decisions.20

**Lessons from Norway**

In the developed world, Norway is a near-perfect model the east African countries can use to assist in developing their oil and gas fiscal and regulation policies. This is one of the countries that has been most able to transform its economy by facilitating development with the newly discovered natural resources.21 Underscoring Norway’s success with natural resource development is the presence of quality institutions and effective fiscal policies. The case of Norway seems to reinforce the assertion that natural resources are transformed into assets by high-quality institutions to promote growth. The contention is that these vast natural resources in the presence of good institutions provide enormous investment opportunities for investors to generate externalities with positive trickle-down effects on all sectors of the economy.22 These institutions also lead to formulation of effective regulations and fiscal policies that stimulate development of the exploration and production of oil and gas. However, to borrow from Norway, it is important to understand the major differences the country has with other countries that have not benefitted from natural resources. First, Norway had good and well-developed institutions prior to and after its oil and gas discovery. There was an entrenched rule of law, property rights and developed state institutions to regulate the oil and gas industry. Furthermore, they had a long and stable democratic governance system based on broad political representation and effective civil society that helped check resource grabbing activities. It also had a well-functioning state bureaucracy that facilitated the elimination

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of inefficiencies and waste in the system. Although natural resources provide economic opportunities to all its host countries, it is not sufficient to provide the needed growth and development. It will require good political systems and deliberate policies to translate these economic opportunities into tangible developments. In this regard, the success story of Norway in the management of its oil and gas resource is due to its political system and policy decisions. There were some policies that were adopted in Norway that have transformed its natural resources into a blessing and not a curse, and which have distinguished it from most of its counterparts.

The Norwegian policy calls for strong governmental participation and control. This contrasts with what prevails in many other oil producing countries. The East African Countries have systems where the government is deeply involved through the PSCs. But what the East African region may lack now are strong institutions devoid of partisan politics. Another policy decision in the mix is the policy choice of consensus building on issues of long-lasting national interest. On issues of security, foreign policy, fiscal policy, social spending and state welfare, Norwegians have always built consensus void of partisan politics. The oil industry and oil revenue is one such area that has received unanimous assent with regards to its management in the national interest. Further, Norway made a deliberate effort to be inclusive of local interest. This allowed informal supervision of the oil sector by trade unions and employers associations. The policy direction allowed active participation of unions in the oil companies and state institutions in the oil industry, to serve as checks on state power, and mismanagement of oil resources and corruption. Further, Norway has a unique policy on distribution of oil rents. This policy focuses on two primary dimensions: first, the distribution of oil windfalls within the society in a specific generation, and second, the distribution between generations. In ensuring fairness and equity in the distribution of oil rents within the society, Norway’s policy choices espouse welfare state expansion which provides benefits to the poor against tax cut regime that benefits the rich. This regime has reduced risk and uncertainty in fiscal and management in the oil and gas sector. Moreover, what

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is overriding in the road to proper fiscal management and regulation in the oil and gas sector is an effective political system with the will to implement and enforce the formulated regulations and policies. These two factors are not mutually exclusive, and the absence of one may hinder efforts at avoiding the curse of resource abundance. The success story of Norway presents good lessons for other oil-rich countries that are still grappling with the negative consequences of natural resource endowments, and particularly, for new entrants like Kenya, Uganda and Tanzania. Although the East African countries have a lot to learn from the Norway experience, they must guard against wholesale copying of policies and structures without regard to their local context.

Implications

To reap the benefits of the opportunities arising from the extraction of oil and gas, countries in East Africa need to have strong institutions to lead regulation and fiscal issues. The presence of natural resources in a dysfunctional institutional environment precipitates predation, rent-seeking, destructive and unproductive activities that result in externalities that impact negatively on the entire economy. All may not be well with institutional set up prior to the first oil or gas production in any of the three East African countries. The institutions still seem weak. There seems to have been a conscious or unconscious, but subtle, attempt by the various governments at weakening institutions, particularly those mandated to ensure transparency and accountability, in order to promote their parochial ends. The failure by government to legislate appropriate laws and adequately to resource key state agencies that should play important roles in the oil and gas industry before production begins could be part of the grand strategy to incapacitate these institutions to facilitate corruption and plundering of resources.²⁴

Regulations are important as long as they are enforceable. In other words, good legislations and fiscal policies in the absence of agencies to ensure their enforcement have a deleterious impact on growth promotion and development. The regulators in the emerging oil industry in Kenya, Uganda and Tanzania should be strengthened to ensure that they are competent and capable of ensuring that regulations and policies are adhered

to. The three governments should ensure that those regulations and policies that are appending are finalized and passed. Further, the fiscal policies that are conflicting with PSCs should be harmonized to have standardized regulation and fiscal policy in regard to oil and gas sector. This will go a long way in ensuring that uncertainties on regulation and taxation in the sector are reduced and, hence, investments and activity in the sector will improve.

Further, any deliberate effort to introduce partisan politics in the oil and gas sector should be categorically rejected. Fiscal policies and any legislation should be aimed at developing the sector and economically advancing the region. The deliberate attempts by some ruling elites to incapacitate the regulatory agencies in order to execute their self-seeking agenda must be resisted; additionally, the genuine lack of funds and managerial ineptitude must be avoided; and finally, after the oil and gas discovery is matured, the relevant institutions must not be under-resourced and made incapable of responding appropriately to the challenges of the oil and gas sectors. The important role of these regulators in the oil and gas industry require that they are fully mandated, well resourced in terms of personnel, training and equipment, and supported to discharge their duties to avoid the historical resource curse of hydrocarbon booms.

The long-term nature of PSC projects means that some contractual changes are likely to be necessary during the life of the project. Changes are related to various issues, such as introduction of the new fiscal imperatives, greater government control, and reassessment of contractual risks. Minimizing the need for these changes avoids conflicts between the various partners. In any case, the successful development of a PSC requires adequate institutional facilities. Extensions of research directions can provide more insight into the needs for institutional capacity-building to support contractual changes in the PSCs. These involve not only the modification of financial schemes, procedures and regulation, but also developing rules, conducting research, and compiling and exchanging experiences among the parties. Appropriate procedures for dealing with change should also be built into the contract. This includes procedures to ensure that the mutual interests are maintained when contract changes might occur. More importantly, the government
and the exploration and production companies should seek to understand each other's businesses and should have a common vision, a priori, of how they will work together to achieve a mutually successful outcome to the project (oil exploration and production).

Authorities in the East African region should regularly reassess their relationships with contractors to identify ways in which relationships can be improved within the context of the original understandings and agreements. In practical terms, however, the success of PSCs will be not only determined by the willingness of the government to encourage and support the exploration and production investment on the PSC terms, but also to align the incentives of the agreements over the life of the contract and maximize the economic value of the resources without needing repeated re-contracting. This is bound to reduce regulatory and tax risks that are enshrined into the various PSCs in the oil and gas exploration and production sector.

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Fiscal Incentives Act Chapter 85:01, Act 22 of the Laws of Trinidad and Tobago.


Petroleum Act Chapter 62:01, Act 46 of 1969 of the Laws of Trinidad and Tobago.
