Oil and gas taxation in Ethiopia

January 2016

Contents

Deloitte Taxation and Investment Guides
www.deloitte.com/taxguides
Oil and Gas Tax Guide

Tax professionals of the member firms of Deloitte Touche Tohmatsu Limited have created the Deloitte International Oil and Gas Tax Guides, an online series that provides information on tax regimes specific to the oil and gas industry. The Guides are intended to be a supplement to the Deloitte Taxation and Investment Guides, which can be found at **www.deloitte.com/taxguides**.

For additional information regarding global oil and gas resources, please visit our website:
www.deloitte.com/oilandgas

1.0 Overview

1.1 History

Apart from a brief period of Italian occupation between 1936 and 1941, Ethiopia successfully resisted the "Scramble for Africa". It was a monarchy until 1974, when the last emperor, Hailie Selassie, was deposed by a military junta (the "Derg") which imposed a socialist system. Following years of internal strife and appalling famines, the Derg was overthrown in 1991.

The first multi-party elections were held in 1995. For two decades Ethiopian politics was dominated by Prime Minister Meles Zenawi, the charismatic leader of the movement which defeated the Derg. His coalition, the Ethiopian People's Revolutionary Democratic Front, remains the ruling party. Following his death in 2012, power was passed to his deputy Hailemariam Desalegn. Parliamentary elections were held in May 2015 with the ruling party retaining power.

Though one of the fastest growing economies in Africa, Ethiopia still has one of the lowest GDPs per capita, and the economy has not been fully liberalized. The key financial services and telecoms sectors are closed to foreign investment. Agriculture, particularly coffee production, remains a key part of the economy, although poor farming practices and low levels of investment still leave parts of the country vulnerable to drought and famine. Despite the threat of drought, mountainous Ethiopia has huge potential for hydropower for both the domestic market and export; the government has initiated a plan to increase generation capacity to 15GW by the end of 2015.

Ethiopia is land-locked following Eritrea's independence in 1993 and tensions remain with that country.

1.2 Key facts

Population: 96.6 million (July 2014 estimate)

Median age: 17.6 years (July 2014 estimate)

Currency (code): Ethiopian Birr ("ETB")

Exchange rate at 4 September 2015: ETB 20.8777 = US$ 1

Exchange controls: Ethiopia's central bank administers a strict foreign currency control regime and the local currency, ETB, is not freely convertible.

GDP (purchasing power parity): $118.2 billion (2013 estimate)

GDP per head of population: $1,300 (2013 estimate)

GDP Growth: 9.9% (2014 estimate)

Principal industries: Food processing, beverages, textiles, leather, chemicals, metals processing and cement

Official language: Amharic

Unemployment: 17.5% (2012 estimate)

Hydrocarbon production: 100 barrels per day (2012 estimate)

Petroleum product usage: 49,080 barrels per day (2011 estimate)

Legal system: The federal constitution was promulgated by the transitional authorities in December 1994. In May 1995, representatives were elected to the institutions of the new republic, which entered into force in August 1995.

Head of State: President Mulatu Teshome Wirtu

Head of Government: Prime Minister Hailemariam Desalegn

Note – prior to his approval as prime minister, Hailemariam had been acting prime minister due to the death of former prime minister Meles.

Transparency International corruption perception index 2014: 33 (ranked 110 of 175 countries)

1.3 Industry overview

Ethiopia currently has no commercial production of hydrocarbons, though there have been significant gas discoveries and signs of oil.

Ethiopia has six basins which may contain commercial hydrocarbons: Ogaden, Abay, Gambella, Omo, Chew Bahir and Mekele. US Company Tenneco discovered two gas fields in the Ogaden Basin in the early 1970s: Calub (estimated at 2.7 trillion cubic feet ["tcf"]) and Hilala (estimated at 1.3 tcf). These have had a troubled history and are still not in production. Following the overthrow of Emperor Hailie Selassie, Tenneco was expelled by the Derg in 1977 and further work was then carried out at the fields by a Soviet exploration company. They, in turn, left Ethiopia following the fall of the Derg, and in 2007 Petroleum Production Sharing Agreements ("PPSA") were awarded to Petronas. Petronas left Ethiopia in 2010 as a result of a portfolio rationalization exercise and the blocks were then awarded to a private Hong Kong-based company, PetroTrans. PetroTrans rapidly fell out with the Ethiopian government and is reported to be taking its dispute to international arbitration. Meanwhile, local media reports that another Chinese company, Poly GCL Petroleum Investment Ltd, has signed new PPSAs for the blocks.

The Chew Bahir and Omo basins lie in the East Africa Rift system and have attracted particular interest since Tullow Oil's success in the nearby and geologically similar Lake Turkana region of Kenya. Tullow and its partner, Africa Oil, drilled two wells in the South Omo block during 2013. Whilst neither confirmed the presence of commercial hydrocarbons, the companies issued optimistic press releases and confirmed their intention to drill further wells in the area during 2014.

In February 2014, it was reported that the El Kuran-3 well in the Ogaden Basin (the operator is New Age) had encountered oil and gas shows and that they will continue drilling to a depth of 3,500 metres to test deeper strata.

Operator	Block Name	Partners
AFAR EXPLORATION	AFAR BLOCK	–
AFRICA OIL CORP	ADIGALA	GENEL ENERGY, NEW AGE (GAE) LTD
	RIFT BASIN	–
CALVALLEY PETROL	METEMA	–
TULLOW OIL PLC	SOUTH OMO	AFRICA OIL CORP, MARATHON OIL CORP
TRANSGLOBAL PETROLEUM	**AFAR TIGRAY**	**–**
FALCON PETROLEUM	**ABAY-1**	**–**
	ABAY-4	–
	ABAY-7	–
PEXCO NV	OGADEN 18	–
	OGADEN 19	–
	OGADEN 21	–
NEW AGE (GAE) LTD	OGADEN 7	AFRICA OIL CORP, AFREN PLC,
	OGADEN 8	AFRICA OIL CORP, AFREN PLC,
SOUTHWEST ENERGY BVI	OGADEN 9	–
	OGADEN 9A	–
	OGADEN 13	–
	GAMBELLA	–
	JIMMA	–
Poly-GCL	OGADEN 3 & 4	–
	OGADEN 11 & 15	–
	OGADEN 12 &16	–
	OGADEN 17 & 20	–
	Calub & Hilala	–

Source: See Appendix 1

1.4 Regulatory environment

Ethiopia's economy is not yet fully liberalized, though significant steps are being taken to encourage foreign investment in key sectors. Hydrocarbon exploration is still a relatively low priority for the government, though this is starting to change given the large discoveries elsewhere in the region.

The legal foundation for upstream activities in Ethiopia is the Proclamation to Regulate Petroleum Operations ("Proclamation 295/1986") issued by the Derg in March 1986 and still in force. This is available in English and Amharic on the website of the Ministry of Mines of Ethiopia ("MoM") (http://www.mom.gov.et/). The MoM combines the functions of policy maker, regulator and, in the absence of a national oil company, commercial partner in upstream projects, though the latter function has not so far been exercised.

Proclamation 295/1986 is brief but fairly comprehensive in its coverage of upstream issues. It states that, in respect of issues covered, it takes precedence over any other Ethiopian laws, specifically those related to mining. It should be noted, however, that conflict of laws remains a key issue for investors as conflicting laws often state that they take priority over all other laws. The Proclamation provides the following, amongst other matters:

- The Government of Ethiopia, acting via the MoM, may enter into agreements (i.e. PPSAs) to undertake petroleum operations.
- In addition to PPSAs, non-exclusive agreements are possible in order to carry out geological and geophysical ("G&G") surveys.
- PPSAs may be awarded after competitive bidding or exclusive negotiation.
- Preference is to be given to employment of Ethiopians and to procurement of Ethiopian goods and services. No minimum percentages are provided.
- Direct assignments of PPSA interests require ministerial consent.
- Customs exemptions are provided for contractors and subcontractors in respect of goods imported for petroleum operations.
- Expatriate employees are exempt from personal income tax.
- Exchange control regulations are relaxed for contractors and subcontractors.

Ethiopia has adopted production sharing as a basis for its engagement with international oil and gas companies. Hydrocarbons in the ground are the property of the state and are to be shared once produced under the framework of a PPSA. A Model PPSA ("MPPSA") is posted on the MoM website. The MPPSA follows international standards fairly closely as per the below:

- Contractors may be Ethiopian or foreign legal entities, but in both cases they should maintain offices in Ethiopia (which implies registration of a branch in the case of a foreign legal entity). Negotiable government equity participation is provided (either directly or via a nominee) with no obligation to reimburse exploration costs. An interest-bearing loan is required from the Contractor to fund the government's share of development costs.
- A cost recovery cap is provided but the amount is negotiable.
- Profit hydrocarbons are shared on the basis of volumes produced (i.e. no R-factor or other return-based criterion). Financing costs (except in respect of funding exploration) are cost-recoverable subject to arm's length tests.
- The Contractor is required to sell oil to the state under certain circumstances, but the amount should be proportionate and paid for in US Dollars ("USD") at market value as determined under the PPSA.
- Rentals, royalties and bonuses are provided for, but the amounts are negotiable.
- The contractor and subcontractors are subject to Ethiopian tax legislation (see below).
- Foreign exchange control relaxations reflect those in Proclamation 295/1986 as do the exemptions from import taxes and personal income tax for expatriates.
- A standard form of accounting procedure is included.
- The MPPSA does not provide for an additional profits tax or other form of windfall tax.
- There is no provision for the establishment of a decommissioning reserve.

2.0 Corporate income tax

2.1 In general

Income tax matters in Ethiopia are generally governed by the Income Tax Proclamation No.286 of 2002 ("Proclamation No. 286/2002"). There are specific tax rules, albeit brief, applicable to upstream petroleum activities set out in the Petroleum Operations Income Tax Act Proclamation No. 296 of 1986 (Proclamation No. 296/1986) which states that it overrides any other legislation in the event of a conflict. The MoM website contains a link to this.

2.2 Rates

Contractors and subcontractors are taxable in accordance with the general Income Tax Proclamation at a rate of 30%, regardless of whether they are subsidiaries or branches of foreign legal entities.

2.3 Taxable income

The base for calculating income tax is revenue from the Contractor's share of production less allowable deductions, including tax depreciation. This calculation is entirely separate from the calculation of profit hydrocarbon sharing under the PPSA, but should be based on the accounting records prepared in USD in accordance with the Accounting Procedure and "generally accepted international petroleum industry practice".

2.4 Special deductions for oil and gas companies

Exploration and other costs incurred before the commencement of "regular production" are to be capitalized and depreciated at 20% per annum on a straight-line basis from the period in which regular production commences. Other capital expenditure is to be depreciated on the same basis from the year incurred.

Decommissioning costs may only be deducted in the year incurred.

Interest on debt that is on arm's length terms is deductible, unless used to fund exploration.

2.5 Losses

Losses may be carried forward for up to ten years. There is no provision for loss carry-back.

There is no fiscal consolidation of separate legal entities, but no income tax ring fence where more than one PPSA is held by a single legal entity, so results may be consolidated for purposes of calculating income tax.

2.6 Taxation of subcontractors

Proclamation 296/1986 also provides rules for the income tax treatment of foreign subcontractors. "Subcontractors" are defined as persons "with whom a contractor establishes a contractual relationship for the provision of services required for performance under a petroleum agreement" (i.e. a PPSA). There is no separate definition of "foreign subcontractors" however, ordinarily this would mean companies which are not registered in Ethiopia. The definition excludes lower tier subcontractors, who will therefore be subject to general income tax rules. Specific provisions in Proclamation 296/1986 applicable to foreign subcontractors are:

- Services provided outside a 'development area' are exempt from income tax. A development area is a location which has a commercial discovery approved for development by the Minister of Mines.
- A foreign subcontractor performing services for a contractor in relation to a development area will be subject to income tax. The tax is collected via a withholding mechanism which is applied at the rate of 3% (which is equivalent to the 30% statutory rate applied to a deemed margin of 10%). The tax base excludes mobilization, demobilization and reimbursable costs.

It should be noted that these provisions apply only for income tax purposes. For example, they do not relieve subcontractors from the obligation to account for Value Added Tax ("VAT"). The income tax exemption for exploration stage activities conflicts with the general income tax law that would potentially deem a permanent establishment in respect of service activities carried out in Ethiopia. General Law provides for a 10% withholding tax ("WHT") on payments for technical services provided by non-registered non-residents.

3.0 Other corporate income tax

3.1 Additional profits taxes

Additional profits taxes are not applicable in Ethiopia.

3.2 State taxation

Not applicable

3.3 Assignment of petroleum interests

Proceeds from the disposal of interests in a PPSA that have commenced "regular production" are treated as receipts from petroleum operations. This implies no adjustment to tax depreciation pools, though this is untested in practice. The acquirer is entitled to relief on the amounts paid (including any premium) as capital expenditure subject to 20% per annum tax depreciation on a straight-line basis.

Proceeds from the disposal of interests in a PPSA that is still in the exploration phase may be offset by costs incurred in respect of the interest transferred. This implies apportionment of the base cost where there is a part disposal.

The net proceeds are taxable at the applicable income tax rate of 30%.

4.0 Tax incentives

4.1 Income tax deductions

See Section 2.4

4.2 Custom duty exemptions

Both the MPSSA and Proclamation No. 295/1986 provide exemptions to both the contractors and subcontractors in respect of goods imported for petroleum operations.

4.3 Value Added Tax exemptions

There is no VAT exemption available but oil companies in the exploration and development phase may register for VAT even if they are not yet generating income enabling them to recover the input VAT incurred in their operations. Please refer to section 8.0 for further information.

5.0 Payments to related parties

5.1 Transfer pricing

There is no specific transfer pricing legislation but transactions between related parties are required to be made at arm's length.

5.2 Thin capitalization

If upstream companies in Ethiopia are thinly capitalized, interest in excess of the acceptable gearing ratio will not be deducted for tax purposes. Thin capitalization does not apply to a branch. An entity is deemed to be thinly capitalized when the debt to equity ratio exceeds 4 to 1.

5.3 Interest deductibility

Interest is generally deductible unless it has been incurred for exploration activities subject to further limitations imposed by thin capitalization rules.

6.0 Transactions

6.1 Asset disposals

See section 3.3 for a discussion on the disposal of oil and gas license interests and assets.

7.0 Withholding taxes

7.1 Dividends

General tax law provides a 10% withholding tax ("WHT") on dividends paid to non-residents. Proclamation 296/1986 provides an exemption from this in respect of profits derived from petroleum operations. There is no branch profits tax in Ethiopia.

7.2 Interest

Subject to the terms of any applicable Double Tax Treaty ("DTT"), interest on debt that is on arm's length terms is deductible (unless it is used to fund exploration). General tax law provides WHT at a rate of 10% on interest paid to non-residents.

7.3 Royalties

Subject to the terms of any applicable DTT, WHT at the rate of 5% applies on all royalty payments made to resident and non-resident persons.

7.4 Professional and management fees

Management and professional fees paid to resident persons are subject to WHT at the rate of 30% and 10% if paid to non-resident persons.

7.5 Tax treaties

Ethiopia has DTT with less than ten countries which determine the circumstances under which Ethiopia has taxing rights and prescribe the applicable WHT rates in many cases.

8.0 Indirect taxes

8.1 Value-added tax

Ethiopia has a value-added tax ("VAT") regime which is consistent with international norms. Companies involved in exploration and development are entitled to register for VAT even if they are not yet generating income. Input VAT incurred in this period is repayable in principle, although as in many emerging markets, in practice it may be hard to recover, particularly if the amounts are substantial.

Services provided outside Ethiopia are subject to a reverse charge mechanism which requires payment of VAT on imported services. This then becomes creditable input VAT recoverable subject to normal rules.

It should be remembered that the upstream industry is still in its infancy in Ethiopia and there are many uncertainties in law and practice.

The VAT rate in Ethiopia is 15%.

8.2 Import, export, and customs duties

Both the MPSSA and Proclamation No. 295/1986 provide exemptions to both the contractors and subcontractors in respect of goods imported for petroleum operations.

8.3 Stamp duty

Stamp duty is payable at varying rates on qualifying chargeable instruments in Ethiopia.

The rates are provided in the table below.

8.4 Employment taxes

Personal income tax rates vary from 10% to 35% and the tax base includes most benefits in kind. Employers are required to deduct tax at source. In addition, there is a mandatory social security contribution for Ethiopian nationals: the rate is 11% for the employer, and 7% of remuneration for employees.

Expatriate employees in the oil and gas industry are exempt from personal income tax.

Instruments chargeable with stamp duty	Basis of valuation	rates of stamp duty
Memorandum and Articles of Association of any business organization or any association	Flat	350 ETB (upon first execution)
100 ETB (upon any subsequent execution		
Memorandum and Articles of Association of cooperatives	Flat	35 ETB (upon 1st execution)
10 ETB (upon subsequent execution)		
Award	On value	1% (with determinable value)
35 ETB (with undeterminable value)		
Bonds	**On value**	**1%**
Warehouse bond	On value	1%
Contracts and agreements and memoranda thereof	Flat	5 ETB
Security deeds	On value	1%
Collective agreements	Flat	350 ETB (on first execution)
100 ETB (on any subsequent execution)		
Contract of employment	Salary	1%
Lease including sub-lease and transfer thereof	On value	0.5%
Notarial act	Flat	5 ETB
Power of Attorney	Flat	35 ETB
Register title to property	On value	2%

9.0 Other

9.1 Choice of business entity

Business in Ethiopia can be undertaken through subsidiaries, branches of foreign legal entities, partnerships, trustees and sole proprietorship. The most common type of business entities are subsidiaries and branch entities.

9.2 Foreign currency

The MPPSA prescribes USD accounting.

9.3 Exchange Controls

Ethiopia retains currency control regulations but these are relaxed under the MPPSA and Proclamation 295/1986.

9.4 Fiscal stability

The Ethiopian tax legislation does not provide for fiscal stability, however the MPPSA provides for an economic stabilization clause that enables the oil and gas companies to apply to renegotiate the fiscal terms in the event of an adverse change in the prevailing legislation.

10.0 Oil and gas contact information

Addis Ababa, Ethiopia (GMT + 3)

Deloitte & Touche
Deloitte Consulting
Ethio-China Friendship Avenue
Mina Building, 5th Floor
P.O. Box 25701
Addis Ababa

Getu Jemaneh
Tax Partner,
Deloitte Ethiopia
Email: gjemaneh@deloitte.com
Telephone: +251 (0) 115 527666

London (GMT)

Deloitte LLP
2 New Street Square
London, EC4A 3BZ
United Kingdom

Julian Small
Tax Partner, Global Oil and Gas Tax Leader
Email: jsmall@deloitte.co.uk
Telephone: +44 (0) 20 7007 1853

Appendix 1

Sources:
Afren Plc (http://www.afren.com/operations/ethiopia/)
Africa Oil Corp (http://www.africaoilcorp.com/s/block-summary.asp)
All Africa (http://allafrica.com/stories/201402220141.html)
BBC Country Profile (http://www.bbc.co.uk/news/world-africa-13349398)
CIA World Factbook (https://www.cia.gov/library/publications/resources/the-world-factbook/)
National Bank of Ethiopia (http://www.nbe.gov.et/)
Southwest Energy BVI (http://sw-oil-gas.com)
The Economist Intelligence (http://country.eiu.com/ethiopia)
The Reporter Ethiopia (http://www.thereporterethiopia.com/index.php/news-headlines/item/2507-new-uk-company-acquires-oil-exploration-blocks-in-ogaden)
Transparency International (http://www.transparency.org/research/cpi/overview)
Tullow Oil Plc (http://www.tullowoil.com/Media/docs/default-source/operations/tullow-group-licence-list-march-2015.pdf?sfvrsn=6)

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. J4189