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Oil and gas taxation in Kenya

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1.0 Overview

1.1 History

Kenya is a former British colony which became independent in 1963. Its first president, the charismatic Jomo Kenyatta, led the country from 1963 to his death in 1978. His successor, Daniel Arap Moi left power in 2002 after 24 years in office, a period marked by major corruption scandals. Kenya's transition to a stable, democratic government has been somewhat erratic, with continuing allegations of corruption. The 2007 election was followed by widespread violence resulting in the deaths of around 1,500 people. Following the unrest, a peace deal was brokered by former UN secretary general, Kofi Annan, which resulted in the formation of a coalition between the main political parties.

Kenyans voted in a national referendum to approve a new constitution in August 2010, which entailed the creation of a bicameral assembly (a legislative body with two chambers i.e. the Senate & Parliament) and the abolition of the post of Prime Minister. As part of the new constitution, 47 counties, each with a governor and county assembly, have been established. Kenya held a peaceful general election in March 2013 and elected a new President, Uhuru Kenyatta (son of the first president), with William Ruto as his deputy. Devolution to county governments has proved difficult but is progressing. Kenya's economy remains energy starved with restricted access to electricity.

1.2 Key facts

Population: 45 million (July 2014 estimate)

Median age: 19.1 years

Currency: Kenya shilling (KES)

Exchange rate at 1 September 2015: US$ 1= KES 102 (Central Bank of Kenya)

Exchange controls: none, but banks must report foreign exchange transactions in excess of US $10,000

GDP (purchasing power parity): $79.9 billion (2013 estimate)

GDP per head of population: US$1,800 (2013 estimate)

GDP growth: 5.1% (2013 estimate)

Principal industries: small-scale consumer goods, agricultural products, horticulture, oil refining, aluminium, steel, lead, cement, commercial ship repair

Official languages: English, Kiswahili

Unemployment rate: 40% (2008 estimate)

Hydrocarbon production: N/A

Petroleum production usage: 82,000 barrels per day equivalent (2011 estimate)

Legal system: mixed legal system of English common law, Islamic law and customary law

Head of State: President Uhuru Kenyatta

Head of Government: President Uhuru Kenyatta

Transparency International corruption perception index 2014: 25 (placed 145 out of 175 countries)

1.3 Industry overview

Kenya has four prospective sedimentary basins: Anza, Lamu, Mandera and the Tertiary Rift. The Lamu basin extends offshore. BP and Shell carried out exploration work in the 1950s, with the first exploration well being drilled in 1960. Over the past 50 years, many other oil and gas companies have tried their luck onshore and offshore, including Exxon, Total, Chevron, Woodside and CNOOC. Of the 33 wells drilled in the country prior to 2012, 16 showed signs of hydrocarbons, but none were considered commercial. Only four wells had been drilled offshore prior to 2012 and of these, only one (Block L5, drilled by Woodside in 2007) was in deep water.

Following recent successes in Mozambique and Tanzania, offshore exploration has become more attractive and industry confidence was boosted in 2012 by the announcement that Apache's Mbawa-1 well (Block L8) had encountered gas, although this was determined to be non-commercial. With the recent fall in hydrocarbon prices, offshore exploration activities have been scaled down.

Onshore drilling by CNOOC during 2009 in Block 9 (Anza Basin) proved unsuccessful, despite high hopes and reports of gas finds. Tullow Oil farmed into six blocks in the Turkana Rift Basin in late 2010 (five in Kenya and one in Ethiopia). The geology of this area is similar to that in the Albertine Graben of Uganda, and a well drilled in 1992 by Shell found evidence of waxy crude oil similar to that in the Ugandan arm of the Rift Valley. On 26 March 2012, Tullow announced an oil discovery in Block 10BB. A further discovery of oil in Block 13T was announced in November 2012. Subsequently, a total of seven discoveries have been made out of seven wells drilled and the company confirms that there are 600 million barrels of oil in place. Further appraisal activities with a view to developing the discoveries are being undertaken.

Kenya's blocks are currently licensed as follows:

Operator	Block	Consortium partners
ADAMANTINE ENERGY	BLOCK 11B	BOWLEVEN PLC
AFREN	L-18	–
	L-17	–
	BLOCK 1	TAIPAN RESOURCES INC
AFRICA OIL	BLOCK 9	MARATHON OIL
ANADARKO	L-11B	TOTAL, GOVERNMENT – KENYA, PTTEP
	L-12	TOTAL, GOVERNMENT – KENYA, PTTEP
	L-11A	TOTAL, GOVERNMENT – KENYA, PTTEP
	L-7	TOTAL, GOVERNMENT – KENYA, PTTEP
	L-5	TOTAL, GOVERNMENT – KENYA, PTTEP
A-Z PETROLEUM	L-1A	–
	L-3	–
BG GROUP	L-10B	PANCONTINENTAL
	L-10A	PTTEP, PANCONTINENTAL
ERIN	L-16	GOVERNMENT – KENYA
	L-1B	GOVERNMENT – KENYA
	L-27	GOVERNMENT – KENYA
	L-28	GOVERNMENT – KENYA

Operator	Block	Consortium partners
CESPA	BLOCK 11A	EHRC ENERGY, GOVERNMENT – KENYA
EDGO GROUP	L-14	QATAR FIRST INVESTMENTS
ENI	L-21	–
	L-23	–
	L-24	–
FAR LTD	L-6	PANCONTINENTAL OIL
	L-6 ONSHORE	MILIO INTERNATIONAL, PANCONTINENTAL OIL
IMARA ENERGY CORP.	L-2	–
MIDWAY RESOURCES	L-4	SWISS OIL COMPANY, NOCK
	L-13	SWISS OIL COMPANY, NOCK
MILIO INTERNATIONAL	L-20	PACIFIC SEABOARD
NOCK	BLOCK 14T	–
OPHIR ENERGY	L-9	FAR LTD, GOVERNMENT – KENYA, VANOIL ENERGY
PANCONTINENTAL	L-8*	–
PREMIER OIL	BLOCK 2B	TAIPAN RESOURCES INC
RIFT ENERGY CORP	L-19	–
SIMBA ENERGY INC	BLOCK 2A	–
TOTAL	L-22	–
TULLOW OIL	BLOCK 10BA	AFRICA OIL
	BLOCK 10BB	AFRICA OIL
	BLOCK 13T	AFRICA OIL
	BLOCK 12B	SWALA ENERGY
	BLOCK 12A	AFRICA OIL, MARATHON OIL
VANOIL	BLOCK 3B	–
	BLOCK 3A	–

*Pancontinental is reapplying for the L-8 license after operator APACHE left the block

Source: See Appendix 1

Kenya is home to the region's only refinery which is non-operational at present because of differences between the government and former private sector shareholders. The nameplate capacity of the Mombasa refinery, operated by Kenya Petroleum Refinery Limited ("KPRL"), is 80,000 barrels per day. In 2009, Essar acquired a 50% interest in KPRL from a consortium of BP, Shell and Chevron. The remainder is owned by the Kenyan government. At that point it was announced that Essar would invest US$400–450 million in a significant upgrade, however at the time of writing the project is stalled. Essar is reported to have sold its share back to the Kenyan government in late 2014.

1.4 Regulatory environment

The Petroleum (Exploration and Production) Act (the "PEPA") (Cap 308), last revised in 2012, is the principal law governing upstream activities in Kenya. At the time of writing, Kenya is presently reviewing its energy-related legislation including the upstream oil and gas sector and a raft of legislation has been presented to the Parliament of Kenya for debate and enactment.

The PEPA places ownership of hydrocarbons in the hands of the Kenyan government and grants significant powers over the sector to the Cabinet Secretary in the Ministry of Energy and Petroleum. County governments are, however, asking for some powers to regulate aspects of upstream activities taking place in their jurisdictions.

Day to day responsibility for the sector lies with the Petroleum Energy Department of the Ministry of Energy and Petroleum. The PEPA envisages upstream activities being conducted via a state oil company established for that purpose or through contractors under a petroleum agreement, or "in any such other manner as may be necessary or appropriate" (section 4 (3) (b)). The Minister is empowered to sign petroleum agreements on behalf of Kenya and is required to make a model agreement available to potential contractors. This can be downloaded from the website of the state oil company, the National Oil Corporation of Kenya Ltd ("NOCK")[1].

The PEPA is brief and provides little detail, particularly on questions relating to development and production activities, however, there are a couple of points worth noting:

- Where petroleum operations are carried out onshore, the PEPA provides the contractor with right of access to private land at 48 hours' notice subject to various conditions.
- A contractor is required to give preference to locally available goods and services, but there is no definition of what "locally available" means and no specific percentage of local content is prescribed.

NOCK was established in the 1980s to spearhead exploration on behalf of the Kenyan government. This remains a key role, but since 1997 it has also built up a retail business and today controls approximately 5% of the retail market for petroleum products in Kenya.

Key features of the current Model Production Sharing Contract ("MPSC") include:

- Negotiation of an initial exploration period with the possibility to extend this twice.
- An agreed percentage of the contract area is to be surrendered at the end of each exploration period.
- In the event of a commercial development, the total contract duration is negotiable.
- Surface fees are provided for but are negotiable.
- Annual contributions to the Ministry of Energy and Petroleum training fund.
- The PSC does not provide for bonus payments or royalties.
- A negotiable cost recovery cap per period is envisaged, but the amount of this is also negotiable.

1 http://www.nockenya.co.ke

- Capital costs are subject to recovery at a rate of 20% per annum (straight-line).
- The sharing of profit oil is based solely on production volumes with the maximum state share achieved when production exceeds 100,000 barrels per day. The state share may be taken in cash or in kind.
- Separate rules for sharing gas production are not provided.
- Kenya operates a tax paid PSC. This is discussed further below under section 2.1.
- The model provides for an additional allocation of profit oil to the state, triggered when the oil price exceeds a specified threshold.
- In the event of a development, the government has a right to participate directly or via its designee (presumably this would be NOCK). The percentage share to be transferred is subject for negotiation. The PSC envisages that this will not entail reimbursement of costs up to the adoption of the development plan, but the government or its designee will be obliged to fund the respective share of costs thereafter, no carry arrangement being envisaged.
- The contractor is obliged to supply the domestic market out of its share of production in accordance with instructions by the Cabinet Secretary for Energy and Petroleum. This will be at market price.
- The contractor and its subcontractors will be entitled to import goods and equipment for petroleum operations free from customs duties.
- The PSC is subordinate to the laws of Kenya and it is not envisaged that it will be given force of law itself (e.g. by gazetting). In the event of a change in laws or regulations that impacts the economic benefits of a party to the PSC, it is provided that the parties "shall agree to make the necessary adjustments" to restore the status quo.
- In the event of dispute, arbitration is provided for under The United Nations Commission of International Trade Law ("UNCITRAL") rules. This is to take place in Nairobi.
- The accounting procedure specifies the use of US dollars.

2.0 Corporate income tax

2.1 In general

One key feature of Kenya's upstream petroleum regime is the tax paid PSC. This means that the contractor's share of profit oil is received net of income taxes. Income taxes arising from the contractor's petroleum operations under a PSC are carved out of the state's share of production by means of a gross-up calculation (although the methodology for this is not prescribed in detail).

The responsibility for administering taxes in Kenya rests with the Kenya Revenue Authority ("KRA"). The tax year is the calendar year for natural persons, and the financial year which ends in June for all other persons. A change in the financial year requires approval from the Commissioner.

The Kenya Income Tax Act ("KITA") sets out general rules governing the taxation of oil and gas companies in Kenya. The Ninth Schedule to the KITA provides for specific rules applicable to the upstream oil and gas sector. The general rules in the KITA apply to the oil and gas sector where relevant, but the provisions of the Ninth Schedule prevail where there is a conflict.

2.2 Rates

Companies resident in Kenya are taxed on their worldwide income while branches of foreign legal entities are taxed on all income accruing in or derived from Kenya. The corporate tax rate for resident companies is 30% and for branches is 37.5%. There is no branch profits tax or branch remittance tax.

2.3 Taxable income

Taxable income in Kenya generally comprises gross income less deductions provided for in the KITA. The KITA does not presently provide specific or detailed rules for determining the value of sales of hydrocarbons, however it does provide detailed rules on the deductibility of expenses incurred in the exploration, development and production phases.

2.4 Special deductions for oil and gas companies

The Ninth Schedule to the KITA provides for specific deductions against oil and gas income in determining the taxable income.

Exploration costs

Exploration costs, including capital expenditure incurred in undertaking exploration operations, shall be fully deductible for tax purposes in the year in which incurred.

Development expenditure

Development expenditure, excluding plant and machinery and social infrastructure, is depreciated for tax purposes at a rate of 20% per annum (straight-line) commencing the year after the asset is brought into use and the year in which production commences.

Operating costs

Operating costs (including geological and geophysical ("G&G") and intangible drilling costs) are fully deductible in the year incurred.

2.5 Losses

Oil and gas companies are permitted to carry forward losses which are incurred in their operations indefinitely. They can also carry back losses arising in the final year of production for up to three years. No carry back is permitted under general tax rules.

The Ninth Schedule also provides for ring fencing of individual PSCs for tax purposes. A petroleum company must therefore pool income and expenditures arising from the same PSC for the purposes of calculating income tax. This is consistent with the requirements under the MPSC that ring-fence cost recoverability of expenses that have been incurred in a block to the gross production income derived therefrom.

3.0 Other corporate income tax

3.1 Additional profits taxes

Additional profits taxes are not applicable in Kenya however under the PSCs the government's share of profit oil increases if the crude oil price per barrel exceeds a defined threshold.

3.2 State taxation

Not applicable.

3.3 Assignment of petroleum interests

Effective 1 January 2015, Kenya introduced new rules governing the taxation of gains on the direct and indirect disposal of petroleum license interests. Net gains on the direct and indirect disposal of an interest in a PSC in Kenya are taxable at the applicable corporate tax rates of 30% for resident persons and 37.5% for non-residents (i.e. in the case of an interest held via a Kenyan branch of a foreign legal entity).The disposal of interest can be by way of sale, transfer, assignment or exchange and the standard corporate tax rates would apply.

The new rules also seek to tax gains on the disposal of shares in offshore entities where at least 20% of the underlying value is derived from PSC interests in Kenya. However, there is uncertainty as to whether the provisions of the new rules achieve the intention of taxing offshore share disposals. It is also not clear in the KITA what tax rate would apply for the disposal of shares in offshore entities.

4.0 Tax incentives

4.1 Income tax deductions

See Section 2.4.

4.2 Custom duty exemptions

All items except motor vehicles imported by oil and gas companies for direct use in oil and gas exploration and development are exempt from customs duty upon recommendation by a competent authority (The Ministry of Energy and Petroleum).

4.3 Value Added Tax exemptions

Kenya's VAT regime provides for both remission and exemption from VAT with respect to services and goods procured by oil and gas companies for their exploration activities in Kenya.

5.0 Payments to related parties

5.1 Transfer pricing

The KITA provides for general provisions in respect of transactions carried out between related parties. There are detailed transfer pricing requirements set out in the rules enacted in 2006 that establish the guidelines for determining the arm's length price of goods and services transacted between related parties.

5.2 Thin capitalization

Upstream oil companies in Kenya are thinly capitalized if the debt to equity ratio exceeds 3:1. The KITA precludes the deductibility of the interest expense in excess of the permitted debt to equity ratio.

5.3 Interest deductibility

The deductibility of interest is subject to the normal provisions of the Income Tax Act. Interest expenses incurred for business purposes are deductible subject to the limitations imposed by the thin capitalization rules.

6.0 Transactions

6.1 Capital gains

Capital gains tax, which had been suspended since 1985, was reintroduced effective 1 January 2015. Gains arising on the disposal of all qualifying assets by oil and gas companies (except share and license interest disposals, as discussed in 3.3 above) are subject to capital gains tax at the rate of 5%.

6.2 Asset disposals

See section 3.3 for a discussion on the disposal of oil and gas license interests. Please note there are no deferrals or exemptions available from income tax in respect of gains derived on the disposal of an interest in an oil and gas license.

7.0 Withholding taxes

7.1 Dividends

The KITA requires oil and gas companies to withhold tax at a rate of 10% on dividends paid. However, this provision appears to conflict with the provisions of the MPSC which provide that all income taxes including that on dividends are carved out of the government's share of production.

7.2 Interest

Subject to the terms of any applicable double tax treaty, withholding tax at the rate of 15% applies on all interest payments made by oil and gas companies in Kenya to non-resident persons.

7.3 Royalties

Subject to the terms of any applicable double tax treaty, withholding tax at the rate of 20% applies on all royalty payments made by oil and gas companies in Kenya to non-resident persons.

7.4 Service payments

Service payments by oil and gas companies to non-resident subcontractors without a permanent establishment in Kenya are subject to withholding tax at the rate of 5.625%.

7.5 Tax treaties

Kenya has double tax treaties with several countries which determine the circumstances under which Kenya has taxing rights and prescribe for the applicable withholding tax rates in certain cases.

8.0 Indirect taxes

8.1 Value-added tax ("VAT")

In addition to income tax on companies, Kenya operates a VAT system along conventional lines. The standard VAT rate is 16%, but exports are generally zero-rated. Imports of goods and services normally trigger a VAT liability. The model PSC provides an exemption from VAT and customs duty on imports of goods by contractors and subcontractors. The new Kenyan VAT Act, which came into effect on 2 September 2013, also provides for exemption from VAT in respect of supplies, excluding motor vehicles, imported or purchased for direct and exclusive use in oil prospecting or exploration, by a company granted a prospecting or exploration license in accordance with the provisions of PEPA (Cap. 308) upon recommendation by the Cabinet Secretary responsible for energy.

8.2 Import, export, and customs duties

General law also provides an exemption from customs duty on equipment imported for the purposes of exploration and development activities. This mirrors the exemption provided in the PSC, however it does not apply to subcontractors. The Customs and Excise Act was amended by Finance Act 2013, by introducing the Rail Development Levy. This is a levy of 1.5% on the customs value of all goods imported into Kenya for use in the country.

8.3 Stamp duty

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

8.4 Employment taxes

Income tax on employment income is generally collected via withholding at source under Pay As You Earn ("PAYE"). The marginal rate is 30% and additionally employers are required to collect certain social security contributions such as National Social Security Fund ("NSSF") and National Hospital Insurance Fund ("NHIF"). The latter is mandatory for all resident employees (those in Kenya for more than six months). However, employees can be exempted from NSSF contributions where they can demonstrate that they make payments to pension schemes in their host countries.

9.0 Other

9.1 Choice of business entity

Business in Kenya 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

Foreign exchange differences will arise if the loan is denominated and loan repayments are made in a currency other than the functional currency.

Unrealised foreign exchange losses will not be allowed as tax deductible expenses, however they are deductible when realised. Similarly, unrealised foreign exchange gains will not be taxed until realised.

The reporting currency of the financial statements is the functional currency in accordance with IFRS but tax returns must be prepared and submitted to the tax authorities in local currency.

9.3 Exchange Controls

There are no exchange controls, but banks must report foreign exchange transactions in excess of US $10,000.

9.4 Fiscal stability

Tax legislation in Kenya does not provide for fiscal stability, however most PSCs provide 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.

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11.0 Appendix 1

Sources:
National Oil Corporation of Kenya website (http://www.nockenya.co.ke/)
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Essar website (http://www.essar.com/)
KPRL website (http://www.kprl.co.ke/)
Afren PLC website (http://www.afren.com/)
Premier Oil website (http://www.premier-oil.com/premieroil/)
Total website (http://www.total.com/en)
Africa Oil website (http://www.africaoilcorp.com/s/home.asp)
Anadarko website (http://www.anadarko.com/)
PTTEP website (https://www.pttep.com/en/index.aspx)
CEPSA website (http://www.cepsa.com/?lang_choosen=en)
Pancontinental website (http://pancon.com.au/)
Rift Energy (http://www.riftenergycorp.com/)
Edgo Energy website (http://www.edgoenergy.com/index.htm)
Vanoil website (http://www.vanoil.ca/s/Home.asp)
FAR Limited website (http://www.far.com.au/)
Midway Resources website (http://www.midwayresources.com/?print=1)
Milo International website (http://www.milio.com/)
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