Legal regime governing Kenya's oil and gas sector

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11 Jun 2014

Exploration interest in Kenya has surged since the country announced its first oil strike discovery by British explorer Tullow Oil in the country's north two years ago, followed by a number of subsequent finds in the same region. The discoveries have led to increased interest by international oil and gas companies which are keen to position themselves for a stake in the industry.

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In light of the increased interest in the oil and gas sector in Kenya, we have analysed the legal regime governing this sector and set out below some of the highlights to create an understanding for the current and potential players in this industry.

The substantive law is contained in the Petroleum (Exploration and Production) Act and the regulations set out under it. Under the Act, the government may authorise a party (contractor) to engage in petroleum operations within a specified area under a petroleum agreement. The cabinet secretary in charge of energy is authorised to negotiate and sign petroleum agreements on behalf of the government and these agreements are negotiated on the basis of a model production sharing contract (PSC) in the format set out under the regulations to the Act.

Terms of agreements

Only a company incorporated or registered in Kenya under the Companies Act may enter into a petroleum agreement with the government. The government only enters into petroleum agreements with contractors who have the financial ability, technical competence and professional skills necessary to fulfill the obligations under the petroleum agreement. The general terms of such agreements include obligations on contractors to:

- perform certain minimum work and incur certain minimum expenditure during the course of exploration activities;
- develop a work programme and budget for each year of operation;
- give preference to employment and training of Kenya nationals in petroleum operations; and
- give preference to use of Kenyan materials and supplies as long as their prices, qualities, quantities and timelines of delivery are comparable to those of non-Kenyan materials and supplies.

The cabinet secretary is authorised under the Act to map the continental shelf into areas known as 'blocks' which are then opened up, in an auction-style format, to applicants for the negotiation of petroleum agreements.

The government may also elect to participate in petroleum operations and acquire a pre-agreed percentage of the total interest in any area with commercial discoveries. Once the government exercises its option to participate, the affected contractor must transfer to the government the percentage interest specified by the government.

Save for petroleum to be delivered to the government, which takes priority over any other delivery by the contractor, a contractor is entitled to export petroleum produced from its contract area without restriction.

Tax incentives

As Kenya's oil and gas industry is only just coming to life, the tax related provisions of the Act and regulations were initially designed principally to attract upstream sector players. The model PSC contains tax incentives such as the government paying some of the corporate income taxes on behalf of the oil companies. Although significant crude deposits have been discovered in Northern Kenya, none of the players has yet reached the oil production phase so the provisions of the PSC are still relatively untested.

Successive VAT Acts have been consistent in granting VAT exemptions for supplies to licensed oil companies but the associated administrative procedures are rather protracted. The East African Community Customs Management Act also specifically includes an exemption for supplies imported into the territory by an oil exploration company.

With effect from January 2013, a withholding tax that is peculiar to the oil and gas and mining sectors, is levied on the sale of property or shares (including the assignment of rights or the sale of the business). This move appears to target speculators who could potentially make sizeable windfall gains on the sale of exploration blocks.

Refinement expected

Qualifying petroleum service subcontractors (PSS) are subject to a hassle-free final withholding tax of 5.625% on their service fees. From a VAT perspective, as the PSS's services to the oil company are VAT exempt, the PSS cannot claim the VAT on its inputs. Understandably, their service fees are increased to cushion the margins from the impact of the irrecoverable VAT.

As the oil and gas sector grows from infancy, we expect to see further refinement of the regulatory framework to deal with the issues as they arise and we are already aware of ongoing lobbying efforts from players in the sector.

From a constitutional perspective, oil and gas deposits fall under the control of the national government but given the risk of disruption from local communities close to the exploration sites, it is advisable to allow for community engagement and this can potentially be managed at the county government level.

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