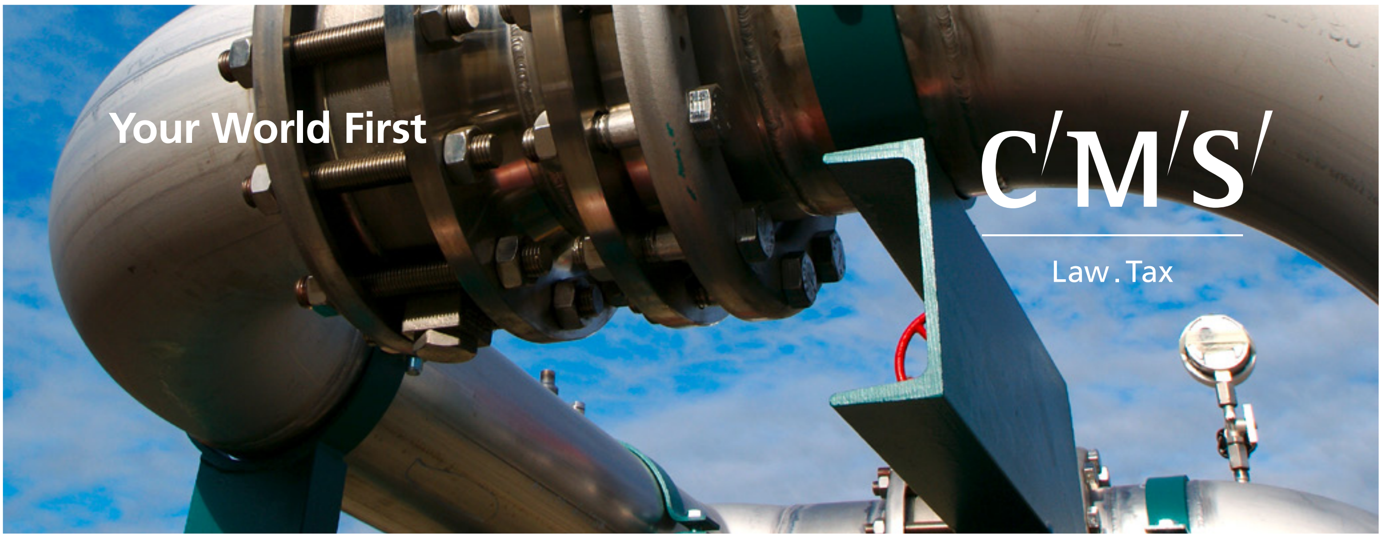

Conducting oil and gas activities in Kenya

Laws and regulations

List the main legislation governing petroleum exploration and production activity in your country.

The main laws governing petroleum exploration and production activities in Kenya are as follows:

— The Constitution of Kenya, 2010 (the '**Constitution**');

— Petroleum (Exploration and Production) Act, Chapter 308 of the Laws of Kenya ('**PEPA**');

— Petroleum (Exploration and Production) Regulations, 1984 (the '**PEPA Regulations**');

— Petroleum (Exploration and Production) (Training Fund) Regulations, 2006 (the '**Training Fund Regulations**'); and

— The Ninth Schedule to the Income Tax Act (Chapter 470, Laws of Kenya) (the '**Ninth Schedule**').

There are numerous other laws which have an impact on the oil and gas sector, including:

— The Land Act, 2012;

— The Occupational Safety and Health Act, 2007;

— The Competition Act, 2010;

— The National Construction Authority Act, 2011; and

— The Environmental Management and Coordination Act, 1999 ('**EMCA**').

There are also proposed laws which will affect the oil and gas sector if passed into law including:

— The Petroleum (Exploration, Development and Production) Bill, 2015 (the '**Petroleum Bill**'), currently in its second reading in Parliament. Once passed, the Petroleum Bill will repeal PEPA and be the new substantive law relating to upstream oil and gas. The Petroleum Bill was concurrently published with draft local content regulations and a new model form production sharing contract ('**PSC**'). Some of the significant changes proposed under the Petroleum Bill and the new model form PSC include:

(a) the creation of an upstream petroleum regulatory authority and a local content development and monitoring unit;

(b) additional new licences and permits for PSC holders such as: (i) drilling permits; (ii) production permits; (iii) underground injection control well permits; and (iv) plugging and abandonment permits. The new permits are to be issued by the proposed upstream petroleum regulatory authority;

(c) a new requirement that the State's entitlement to any profits realised from the exploration and production of petroleum resources is to be shared out between the Government of Kenya (the '**Government**'), the county governments and the local community;

(d) a local equity participation requirement, of at least 5% by an indigenous Kenyan company other than NOCK (as defined below), for a person to be qualified to enter into a PSC; and

(e) new provisions relating to capital gains tax on assignment, environmental provisions, insurance requirements and provisions relating to upstream petroleum operations facilities.

— The Natural Resources (Benefit Sharing) Bill, 2014 (currently in its second reading in Parliament) which is intended to provide a legislative framework for the establishment and enforcement of a system of benefit sharing in resource exploitation between resource exploiters, the Government, county governments and local communities; and

— The Community Land Bill, 2015, which is intended to provide for the recognition, protection, management and administration of community land as defined in the Constitution. The Community Land Bill, 2015 also contains provisions relating to the sharing of benefits arising from investments on community land. This Bill is currently in its second reading in Parliament.

Identify the Government, regulatory and/or oversight bodies principally responsible for regulating oil and gas activities.

— The Ministry of Energy (the '**Ministry**') and the Cabinet Secretary for Energy (the '**Cabinet Secretary**') represents the Government in matters relating to petroleum;

— The National Oil Corporation of Kenya (the '**NOCK**') a state corporation involved in upstream oil and gas exploration;

— The National Land Commission (the '**NLC**') established by the Constitution. The NLC, among other things, is tasked with the management of public land on behalf of the Government; and

— The National Environmental Management Authority established under EMCA, coordinates environmental management activities and the integration of environmental considerations in development plans.

Entry requirements

What are the registration requirements for becoming a licensee of an oil and gas production sharing contract/licence/concession ('Licence') in your country? For instance, is it necessary to incorporate a subsidiary, or register a branch?

The Government may conduct petroleum operations either through NOCK or through private contractors that are licensed by the Government under a PSC. The model form PSC under the PEPA Regulations forms the basis for negotiations between the Government and contractors for petroleum agreements.

Only a company incorporated or registered in Kenya may enter into a PSC with the Government.

PEPA also states that the Government shall only enter into petroleum agreements with contractors who have the financial ability, technical competence and professional skill necessary to fulfil the obligations under the agreement.

Are there any foreign investment approval requirements or restrictions when commencing business in your country (e.g. a minimum local shareholding in the entity undertaking the activity)?

There are no foreign investment restrictions specifically applicable to the upstream oil and gas sector. However, there are local content and local distribution requirements under the model form PSC and local participation requirements under the National Construction Authority Regulations 2014 promulgated under the National Construction Authority Act, 2011 which would apply to upstream contractors.

Licensing

Identify the main fiscal/legal model granting rights to explore and produce oil and gas.

Legal

The Constitution and PEPA state that title to all petroleum existing in its natural condition in strata lying within Kenya and its continental shelf shall vest in the Government. The Government may conduct petroleum operations either through NOCK or through licensed private contractors.

The Cabinet Secretary has the power to divide Kenya and its continental shelf into numbered blocks and may reserve blocks to be exploited by the Government and enter into PSCs with contractors in relation to a specific block.

The Cabinet Secretary may also issue non-exclusive exploration permits for a specified area for the purpose of obtaining geological information.

New article 71(1) of the Constitution provides that the ratification of Parliament is required if an agreement involves the grant of a right or concession for the exploitation of any of Kenya's natural resources. PSCs issued after 27 August 2010 would therefore require parliamentary ratification although the enabling legislation for this requirement has not yet been enacted.

Fiscal

Under the model form PSC, contractors can recover all expenditure incurred in carrying out petroleum operations through disposing of crude oil from the contract area. Petroleum costs incurred in the contract area are recovered either in the year in which the costs are incurred or the year in which commercial production occurs, whichever is later. Capital expenditure in respect of each development area is recoverable at a rate of 20% per annum based on amortisation starting either in the year in which the capital expenditure was incurred or the year in which commercial production commenced. Where the recoverable petroleum costs exceed the value of all cost oil for that year, the excess is carried forward to the succeeding contractual years until the cost is fully recovered. Where the maximum value of cost oil exceeds the petroleum costs, the excess will be accounted for as profit oil which is shared between the contractor and the Government in the ratios set out in the relevant PSC.

Taxes

The Finance Act, 2014 which became effective on 1 January 2015, introduced a new taxation regime for the extractive industry. The Ninth Schedule now governs the taxation of both petroleum and mining in Kenya. The income tax payable on taxable profits by a resident contractor is 30% and 37.5% for a non-resident contractor. The Ninth Schedule also provides for allowable deductions including expenditure relating to exploration, development and decommissioning. It is important to note that the thin capitalisation threshold for petroleum companies is a debt-to-equity ratio of 2:1, which would restrict the deductibility of interest against business income to the extent of the thin capitalisation.

Tax losses incurred by a contractor can be carried forward indefinitely or until operations cease, while losses from petroleum operations can be carried back as a deduction against income for a period of 3 years.

Further, sub-contractors without a 'permanent establishment' in Kenya are subject to withholding tax of 5.625% of the gross service fee; while those with a 'permanent establishment' are taxed on business profits at a rate of 37.5%.

The Ninth Schedule also provides that hedging transactions entered into by a contractor to manage commodity price risk are treated as a specified source of income, unless the transaction has an annual turnover of less than KES 10 million and is approved by the Kenya Revenue Authority's Commissioner for Domestic Taxes, in which case hedging losses or profits can be set off against ordinary business income from oil production. Also, expenditure incurred by a contractor in a contract area can only be offset against income from that contract area during that year.

Pursuant to the provisions of the model form PSC, profit oil is shared between the Government ('**Government Profit Oil**') and the contractor on such ratios as are set out in the relevant PSC. The Ninth Schedule provides, in accordance with the standard provisions of PSCs, that all income tax that a contractor is liable to pay to the Government will be deemed to have been paid as a portion of the Government Profit Oil. However, any taxes due in respect of a gain made on the disposal of an interest in the PSC or any tax that the contractor is liable to deduct from a payment made by the contractor will not be deemed to have been paid as a portion of Government Profit Oil. The net gain from a farm-out transaction is aggregated into the transferor's taxable income and taxed at the relevant corporation tax rate. The net gain is the consideration from disposal reduced by the cost, to the disposer, of the interest. The consideration is taken to be the total amount received or receivable for the disposal, including the fair market value of any amount in kind determined at the time of disposal.

The net gain from the disposal of an interest in a contractor, where the interest derives 20% or more of its value from immovable assets in Kenya, is taxable. Where the interest derives between 20% and 50% of its value directly or indirectly from immovable assets, the net gain is taxable on a prescribed formula. Further, where the interest derives more than 50% of its value from immovable assets in Kenya, the whole gain is subject to tax.

Such a net gain made anywhere in the world on the direct or indirect disposal of an interest in a contractor is deemed to be income derived or accrued from Kenya and is subject to tax in Kenya.

Other fees payable to the Government include:

- **Surface fees:** The PEPA Regulations provide that the contractor shall pay an annual surface fee calculated on the basis of the surface area of the contract area and the exploration period;
- **Signature bonus:** This is a one-time payment on the awarding of a PSC and is payable irrespective of success. Its payment may be spread over the life of the contract; and
- **Training Levy:** PEPA creates a training fund for the purpose of training Kenyan nationals in petroleum operations. The amount payable by each contractor is specified in the PSC.

Please outline the procedure to apply to the Government for an interest in a Licence in your country. Please include details of cost and timing for obtaining such interest.

Currently PEPA allows the Cabinet Secretary to administer the application and the grant of PSCs. The Government intends to introduce a competitive bidding system for new exploration blocks with the highest bidder being awarded the block although this has not yet been introduced.

What is the customary duration of the relevant Licence?

The length of the exploration period under a PSC is not prescribed but is commonly divided into an initial exploration period of 3 years and two additional exploration periods of 2 years each. The Licence may be extended for an additional term on application by the contractor and with demonstration of sufficient proof of need for an extension.

In the event of a commercial discovery, most PSCs continue for a period of 25 years in respect of the area in which the discovery is made from the date when a development plan for the area is approved.

Does the Government have any right to participate and be carried in the Licence? If so, please describe the extent of this entitlement.

Section 28 of the model form PSC provides that the Government may elect to participate in the petroleum operations in any development area and acquire an interest in that development area. The Government may participate either directly or through an appointee. The model form PSC provides for a standard participation agreement to be signed between the contractor and the Government upon exercise of this right by the Government.

On the exercise of its participation rights, the Government is required to assume its share of costs, expenses and obligations incurred in respect of that development area from the effective date of its participation pro-rata to its participating interest.

In relation to historical costs, the model form PSC requires the Government to reimburse the contractor, without interest, pro-rata to its participating interest, its share of all costs, expenses and expenditure incurred in respect of the development area from the date the development plan for that development area was adopted up until the date the Government exercises its right to participate in that development area.

Is there any mechanism for recovery of carry costs?

The reimbursement of the historic costs described above must be made within 3 months of the exercise, by the Government, of its right to participate.

Does the Government have any right to participate in the operatorship of the Licence?

Upon the Government's exercise of its right to participate in a development area, the Government becomes a partner in the operation of the development area through an operating committee established under any joint operating agreement. The original operator of the block would regularly continue as the lead operator and the other entities constituting the contractor, together with the Government, establish a committee to supervise and control petroleum operations on the block. The operating committee consists of one representative from each party involved and its decision making processes will be covered in the joint operating agreement.

Assignment

What Government and/or regulatory approvals are required for the acquisition of oil and gas interests held under a Licence (whether by asset or corporate sale/change of control)?

If any, what are the timing requirements and costs of obtaining such Government and/or regulatory approvals?

Assignment and changes of control under the PSC

The relevant provisions of the model form PSC provide that:

- Where a contractor assigns part or all of their rights to an '**Affiliate**', defined as 'a person directly or indirectly controlling or controlled by or under direct or indirect common control with another person', there is no requirement to notify the Cabinet Secretary;
- Where a contractor assigns to a person other than an Affiliate part or all of their rights and obligations under the PSC the consent of the Cabinet Secretary must be sought (such consent not to be unreasonably withheld) and shall be granted or refused within 30 days; and
- Where a contractor experiences a change of control in its corporate structure there is an obligation to report the change of Control to the Cabinet Secretary. '**Control**' is defined as 'the ownership of at least 50% of the voting rights of a person'. Where one constituent member of a contractor experiences a change of Control, in addition to the need to notify the Cabinet Secretary, the model form PSC states that, 'where control over one of the entities constituting the contractor is changed, the continuation of the contract shall be subject to the consent of the Minister, which shall not be unreasonably withheld'.

Competition approvals

Under the guidelines for the Exclusion of Proposed Mergers from Provisions of Part IV of The Competition Act, 2010, mergers relating to carbon based mineral exploration and prospecting are excluded from notification provided that the value of assets to be held as a result of the merger is below KES 4 billion.

The Common Market for Eastern and Southern Africa ('**COMESA**') has also implemented its own competition regime. Under these amended Rules on the Determination of Merger Notification Thresholds, a merger is notifiable where:

- Both the acquiring firm and the target firm, or either the acquiring or the target firm, operate in two or more COMESA Member States; and
- Either their combined annual turnover or combined assets in the common market is at least USD 50 million and where each of at least 2 parties have an annual turnover or asset value in the Common Market of at least USD 10 million.

Are there any pre-emptive rights reserved to any Government entities in the event of a proposed assignment of an interest held under a Licence? If so, what are the terms upon which such entities are allowed to acquire the interest?

There are no pre-emptive rights reserved to the Government in the event of a proposed assignment of an interest held under a Licence.

Economic support

Are parental guarantees or other economic supports commonly required to be provided by oil and gas companies?

On or before the commencement of any exploration period the contractor is required to provide security, in a form acceptable to the Cabinet Secretary, guaranteeing the contractor's minimum work and expenditure obligations. Most PSCs contain provisions requiring a contractor to obtain a bank guarantee for 50% of the proposed expenditure and a parental guarantee of 50%.

Are security deposits required in respect of work commitments or otherwise?

In addition to the security requirements detailed above, PEPA requires that where a contractor intends to enter upon any private land for the purposes of conducting petroleum operations, it shall, if required by the owner or occupier of the land, give security in such sum and by way of means as the Cabinet Secretary may direct.

Abandonment and Decommissioning

What abandonment regime is in place?

Are security deposits required in respect of future decommissioning liabilities?

Abandonment of wells is addressed under the PEPA Regulations which provide that a contractor shall not, except where there is danger or the risk of significant economic loss, abandon a well without giving 48 hours prior notification to the Cabinet Secretary, and an abandoned well shall be securely plugged to prevent pollution, sub-sea damage, or water entering or escaping from the strata penetrated.

Currently, there are no security deposits required for future decommissioning liabilities but these have been proposed in the Petroleum (Exploration, Development & Production) Bill 2015.

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