Supporting Inclusive Resource Development (SIRD)

East Africa

TRAINING PROGRAM

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Mining, Oil & Gas Contracts in Kenya

SUMAYYA HASSAN
LAW, OIL & GAS, LEADERSHIP, GOVERNANCE

Mining Contracts

Mining Act 2016

Assented to by the President on 6th May 2016

Purpose - to give effect to Articles 60, 62 (1)(f), 66 (2), 69 and 71 of the Constitution in so far as they apply to minerals

Provide for prospecting, mining, processing, refining, treatment, transport and any dealings in minerals.

Does not apply to petroleum and hydrocarbon gases.

Ownership of minerals

S 6(1) Every mineral in its natural state in, under or upon land in Kenya; in or under a lake, river, stream, or water courses in Kenya; in the exclusive economic zone and an area covered by the territorial sea or continental shelf is the property of the Republic and is vested in the National Government in trust for the people of Kenya.

S 8(1) The State has a right of pre-emption of all strategic minerals raised, won or obtained within the territory of Kenya before they are sold.

Administration of the Act

The Cabinet Secretary (CS) in charge of mining is responsible for the administration of the Mining Act and has powers to develop regulations to provide for activities in the mining life cycle.

The Mineral Rights Board will support the CS on administration aspects. Its role is to advise and give recommendations, in writing, to the Cabinet Secretary on the: grant, rejection, retention, renewal, suspension, revocation, variation, assignment, trading, tendering, or transfer of Mineral Rights Agreements; the areas suitable for small scale and artisanal mining; the areas where mining operations may be excluded and restricted among others .

The CS can declare certain minerals or deposits to be strategic by advising and seeking approval of the Cabinet.

The Directorate of Mines and the Directorate of Geological Survey - together, they will manage the activities and information related to mining operations in the country including establishing operational linkages between the national and county governments.

Licencing

"10. A person shall not search for, prospect or mine any mineral, mineral deposit or tailings in Kenya unless that person has been granted a permit or licence in accordance this Act."

"35. (1) A mineral right issued under this Act or any other written law, shall be evidenced by a licence or permit.

(2) The licence or permit referred to under subsection (1), shall be in the prescribed form."

The Act provides for the following operations:

Large scale operations

Small scale operations

The following are the licences available under each of these:

a) Large scale operations:

Licence type	Eligibility	Area	Terms	Restrictions
Reconnaissance licence	Citizen with sound mind, 18 years of age and above, and required technical and financial expertise; or corporate body registered and established in Kenya	· Minimum – one (1) block · Maximum – 5,000 contiguous blocks	§ Maximum: 2 years § Condition: Not renewable § Non-exclusive Work commencement: 3 months from licence approval § Fees: annual charge based on area of recon § Reports: semi-annual and annual § Amendments: Allowable on application to CS	§ Existing mineral rights § Mining licence approved for that area § Finds and data collected are property of GoK; at end of operations all data and records must be surrendered § No subsurface work § Not transferable

Licence type	Eligibility	Area	Terms	Restrictions
Prospecting licence	Citizen with sound mind, 18 years of age and above, and required technical and financial expertise; or corporate body registered and established in Kenya		§ Maximum: three (3) years § Condition: Renewable, not more than two (2) times, not more than three (3) years § Exclusive § Work commencement: 3 months after obtaining licence approval or at approved time in work program § Fees: None § Reports: Issued quarterly or on requirement basis by the CS § Amendments: Allowable on application to CS	§ Minerals found belong to the national government § Obligation to notify of any discoveries immediately § Not transferable unless under consent by cabinet secretary § Work program budgets must be paid to MoM if work obligations are not met within stipulated time. § Renewals submitted 3 months before expiry § Relinquishment required with each renewal: minimum of 125 blocks and not less than ½ the number of blocks § Contiguous prospecting licences for same term and mineral are consolidated

Licence type	Eligibility	Area	Terms	Restrictions
Retention licence	§ Holder of prospecting licence that has identified a mineral deposit with potential commerciality but deposit cannot be developed immediately	Same as prospecting licence or mining licence	§ Maximum: two (2) years § Condition: Applies to an area whole, or a part, of the area covered by a prospecting licence. § Condition: Renewable, once and for not more than two (2) years	§ CS may compel holder to apply for mining licence, if discoveries are commercial and recoverable § Licence may be revoked if holder of retention licence doesn't show just cause for declined application

Licence type	Eligibility	Area	Terms	Restrictions
Mining licence	§ Citizen with sound mind, 18 years of age and above, and required technical and financial expertise; or corporate body registered and established in Kenya § Holder of prospecting licence who has notified CS of discovery in their licenced areas	Same as prospecting licence, recon licence, or retention licence	§ Maximum: 25 years or forecast life of the mine (whichever is shorter) § Condition: Exclusive § Condition: Renewable, for maximum of 15 years or life of the mine, whichever is shorter § Work commencement: 6 months after obtaining licence approval or at approved time in work program § Reports: Issued quarterly or on requirement basis by the CS § Amendments: Allowable on application to CS	§ Cannot be issued on land which is the subject of a prospecting licence, reconnaissance licence, a retention licence unless the applicant is holder of above licences or a new applicant has consent from the above licences holders § Renewals submitted 1 year before expiry § Obligation to notify of any new/additional discoveries immediately § Obligation to notify CS of: § cessation of activities – at least 6 months § suspension – at least 3 months § curtailment – at least one month § or otherwise within 3 days of halting events

Licencing cont.

b) Small scale operations:

Licence type	Eligibility	Area	Terms	Restrictions
Reconnaissance permit	Citizen or corporate body with at least 60% shareholding by citizens	Not specified	Non-exclusive rights	§ If rights are over community land, must have consents from community land administrators or county governments, if community land is un-alienated § Consent will be given by signing a legally binding agreement with Government or mining rights holder, or adequate compensation

Licence type	Eligibility	Area	Terms	Restrictions
Prospecting permit	Citizen or corporate body with at least 60% shareholding by citizens	§ Minimum – not specified § Maximum – 2 contiguous blocks	§ Maximum: 5 years § Condition: Renewable, once for a max of 5 years	Doesn't specify whether rights are exclusive or non-exclusive

Licence type	Eligibility	Area	Terms	Restrictions
Mining permit	Citizen or corporate body with at least 60% shareholding by citizens	§ Minimum – not specified § Maximum – 2 contiguous blocks	§ Maximum: 5 years § Condition: Renewable, for maximum of 5 years or life of the mine, whichever is shorter § Exclusive rights	

MINERAL AGREEMENTS

Section 117. (1) The Cabinet Secretary in consultation with the National Treasury may enter into a mineral agreement with the holder of a mining licence where the proposed investment exceeds five hundred million United States dollars.

(2) A mineral agreement shall include terms and conditions relating to –

(a) the minimum prospecting or mining operations to be carried out and the time table determined for purposes of such operations;

(b)the minimum expenditure in respect of the prospecting or mining operations;

(c) the manner in which prospecting or mining operations shall be carried out;

(d) the environmental obligations and liabilities, subject to the requirement of the Environment Management and Co-ordination Act;

(e) the procedure for settlement of disputes;

(f) the processing, whether wholly or partly in Kenya, of any mineral or group of minerals found, obtained or mined by the holder of a mineral right in the course of mining operations;

(g) the basis on which the market value of any mineral or group of minerals in question may from time to time be determined;

(h) insurance arrangements;

(i) resolution of disputes through an international arbitration or a sole expert; and

(j) community development plans;

(k) the payments of royalties, taxes, cess and other fiscal impositions; and

(l) financial arrangements.

(3) Nothing contained in a mineral agreement shall be construed as to absolve any party to such agreement from a requirement prescribed by law.

(4) A mineral agreement shall be prepared in accordance with a standard format as may be prescribed in Regulations.

(5) All mineral agreements shall be submitted to the National Assembly and the Senate for ratification.

Local Content

Mineral Right Holders required to give preference to the maximum extent possible to materials, products, services, and workforce from Kenya.

Mineral Rights Holders must submit detailed programmes on recruitment and training of Kenyans. The approval of this program will be a condition for granting of a mineral right.

Mineral Rights Holders required to develop a comprehensive community development agreement that secures socially responsible investment and provides for employment preference for those living in communities around mining operations.

Other provisions

County Government

An office will be established by the CS for Mining and will be the Ministry of Mining representative in the County Government. The office is responsible for granting, renewing and revoking artisanal mining permits, maintaining a register of artisanal miners and maintaining fair-trade.

An officer who reports to Director of Mines will head the office. It will provide training facilities and assistance necessary for effective and efficient artisanal mining operations and facilitates the formation of artisanal association groups or cooperatives for the miners.

Royalties

The Act provides for the payment of royalties by a holder of a mineral right to the State. The royalty payable will be determined by the gross value of the sales. The Act further provides that the Cabinet Secretary will prescribe the rates of royalties payable.

The payments of royalties will be filed with the Mineral Cadastre Office by the 5th business day of every month. Lack of payment of royalties within 60 days of filing is a ground for the licence or permit to be revoked.

The Act states that the royalties collected will be distributed as follows:

70% to national government

20% to county government

10% to the community where mining operations are carried out.

Other provisions cont.

Records and Registration of Mineral Rights

The Act establishes a computerized mining cadaster and registry system, and a register of mineral rights. The computerized mining cadastre and registry system will include an online transactional facility to enable applications for granting and renewal of mineral rights to be submitted online. It will be a public document that will be open to inspection by any interested person upon payment of a fee.

The register will contain details of each application, grant, assignment, transfer, notice, surrender, suspension and cancellation of a mineral right.

Dispute Resolution

The Act provides that any dispute arising as a result of a mineral right issued under the Act, may be determined by the Cabinet Secretary, through a mediation or arbitration process as the disputing parties may agree or as stated in an agreement; or through a court of competent jurisdiction.

Other provisions cont.

Health, Safety and Environment

The Act expects mining operations to comply with laws on water rights and use the land in accordance with the terms of the permit or licence. In addition to this, persons conferred with mineral rights are expected to comply with the Occupational Health and Safety Act.

Before a person is granted a mining licence, they are expected to obtain an Environmental Impact Assessment, Social Heritage Assessment and an Approved Environmental Management Plan.

Regulations

The following regulations have recently been gazetted and are now in effect:

The Mining (Reporting of Mining and Mineral Related Activities) Regulations, 2017 (Reporting Regulations);

The Mining (National Mining Corporation) Regulations, 2017 (National Mining Corporation Regulations);

The Mining (Strategic Minerals) Regulations, 2017 (Strategic Minerals Regulations);

The Mining (Mine Support Services) Regulations, 2017 (Mine Support Services Regulations);

The Mining (Community Development Agreement) Regulations, 2017 (Community Development Agreement Regulations); and

The Mining (Award of Mineral Rights by Tender) Regulations, 2017 (Award of Mineral Rights by Tender Regulations).

Oil and Gas Contracts

Revenue Share Models

These can broadly be classified into royalty and tax (concession), production sharing and service agreements.

<u>Royalties</u>

- In a royalty and tax system, the company takes ownership of the petroleum as it reaches the surface with the government securing its revenue through royalty payments and taxes.
- They are broadly categorised into two types, namely specific or ad valorem and are levied on the extraction of natural resources.
- Specific royalties are based on the quantity of the resource extracted, while ad valorem are charged as a percentage of the value of the resource.
- Specific royalties provide ease of administration, early revenues and are not affected by a fall in prices. Government revenues however do not rise if resource prices increase nor keep up with inflation.
- Ad valorem royalties address some of these concerns through valuation based on prevailing commodity prices.

Service Contracts

Under a service contract, the state hires an oil company both for its technical and financial capability to assume the role of contractor in petroleum exploration and exploitation.

the contractor does not acquire the title to the resource and is simply paid a fixed or variable fee for oil production services.

Production Sharing Contracts

Under the PSC, ownership and right to exploit the petroleum resources remains with the state but an oil company is hired as a contractor to undertake the exploration and exploitation activities.

The state contractor is reimbursed costs incurred by way of entitlement to a portion of that oil ("cost oil") and an additional share of "profit oil".

The contractor bears the exploration and development risks and is not compensated in the event of project failure.

Kenya – Production Sharing Contract & Non-exclusive Permit

The Petroleum Exploration and Production Act of 1986 (Chapter 308) currently governs exploration and production in Kenya's petroleum sector.

"5.
Powers of the Minister
(1)
The Minister may, on behalf of the Government, negotiate, enter into and sign petroleum agreements with a contractor and petroleum agreements shall, subject to the provisions of this Act, be in the prescribed form.
(2)
For the purpose of obtaining geological information, the Minister may grant non-exclusive exploration permits, in respect of areas specified therein, under which a person may enter upon an area and prospect and carry out geological and geophysical surveys."

The specific fiscal terms are set out in a production sharing contract or PSC a model of which is in a schedule to the Act.

The PSC governs the full lifecycle of the oil project.

Key Provisions in the PSC

a) **Signature Bonus**: The model PSC makes no provisions for bonuses or royalties though in practice this is payable as a one-off fee to the Government by the Company upon signing of an oil exploration contract. Signature Bonus negotiation came into effect in 2009.

b)**Surface fee:** is payable and is calculated on the basis of the surface area of the Contract Area on the date those payments are due. $ X per square kilometre per annum during the Initial Exploration Period, $ Y per square kilometre per annum during the first Exploration Period, $ Z per square kilometre per annum during the second Exploration Period and $ AA per square kilometre per annum during the Development and Production Periods.

PSC Provisions cont.

c) **Work programme and expenditure**: The contractor negotiates and agrees on the work programme and minimum expenditure. Initially this was pegged at 15% bank guarantee and 85% parent company guarantee. However, the Ministry revised this and newly licensed companies are required to provide a 50% bank guarantee and 50% parent company guarantee.

Security against non-performance noting that the risk capital is raised through equity.

Small companies (based on their annual turnover criteria), could be required to post 100% bank guarantee.

PSC Provisions cont.

d) **Cost Oil**: This is usually the negotiated percentage of total crude produced for recouping of investment costs incurred by the contractor in exploration and production of oil in a given field. It is a negotiated amount and locally has been up to 60% of all the oil produced in a field.

e) **Profit Oil**: This is the remaining oil after deducting cost oil and is shared between the Government and the contractor.

The division of profits is based on a daily production-based sliding scale system which assumes the first tranche at 20 000 bbl/day and the last tranche at 100 000 bbl/day. The profit splits are negotiable at each tranche, and the state may demand its share in cash or kind.

f) **Ring fencing**: This limits recovery of costs to the area where they were incurred.

g) **Exploration and development phases** – there are three exploration phases the initial period, first additional period and second additional period. The durations are to be negotiated with the government. Development phase is 25 years.

h) **Relinquishment** – at least 25% of the area of the block for each phase.

PSC Provisions cont.

i) **Training fund**

The oil company is obliged to contribute an annual amount to the ministry in charge of petroleum towards the training fund set up to train Kenyans.

j) **Income Tax**

The state's share of profit oil is inclusive of income tax (deemed tax).

k)**Land rights**

The government may at the request of the contractor, make available to the contractor such land as the contractor may reasonably require for the conduct of petroleum operations. If such land is "Trust Land" the government has to follow the relevant constitutional and legislative procedures to set it aside. However, the contractor has to pay a reasonable reimbursement to the government for the setting apart, the use or acquisition of any land for petroleum operations.

PSC Provisions cont.

l) **Local content**

The contractors and sub-contractors have to employ Kenyan citizens in the petroleum operations "where possible" and train these citizens until expiry or termination of the individual contract.

The contractors and sub-contractors should give preference to Kenyan materials and supplies for use in petroleum operations as long as their prices, quantities and timeliness of delivery are comparable with the prices, quality, quantities and timeliness of delivery of non-Kenyan materials and supplies.

m) **Domestic supply obligation**

The contractor may be required to supply the domestic market out of its share of production in accordance with instructions from the Minister. This will be at market price.

PSC Provisions cont.

n) **Capital costs**

Recoverable at a rate of 20% per annum (straight-line).

o) **Participation rights**

In the event of a development, the government has a right to participate directly or via its nominee. The percentage participation interest is to be negotiated. The government will be carried up to development but will have to fund its pro-rata share of costs thereafter.

p) **Customs duties**

The contractor and its subcontractors are entitled to import goods and equipment for petroleum operations free from customs duties.

q) **Windfall Tax**

This is designed to capture additional revenues for the government when the price of oil rises. The windfall tax is assessed against the company share of profit oil that is generated from oil prices that exceed the threshold price as illustrated below:

Windfall tax illustration

(c)When the value of Crude Oil for any calendar quarter calculated in accordance with clause 26 exceeds **US$ 50 per bbl** FOB Mombasa(hereinafter referred to as the "Threshold Price") then a Second Tier Amount is payable by the Contractor to the Government.

The Second Tier Amount will be calculated in respect of each calendar quarter according to the following formula:

R = CSPO x **26%** x (V – Threshold Price)

Where;

R is the Second Tier Amount in US Dollars;

V is the value of crude oil in U.S. dollars for that calendar quarter calculated in accordance with Clause 26 and expressed in US$/bbl, provided that V exceeds the Threshold Price; and

CSPO is the Contractor Share Profit Oil for that calendar quarter in bbl calculated pursuant to clause 27 (3) (a).

PSC Provisions cont.

r) **Confidentiality**

Clause 37.1 of the model contract provides "all the information which the contractor may supply to the Government under this contract shall be supplied at the expense of the contractor and the Government shall keep that information confidential". [Note: the Constitution requires the ratification of concession agreements by parliament and thereby implies the publication of contracts.]

Proposed fiscal system

The Petroleum (Exploration, Development and Production)Bill, 2017 and associated model production sharing contract (PSC)

The new fiscal system that would apply to PSCs negotiated in the future will be significantly different than the one that applies to all existing PSCs

First, the proposed model PSC proposes to replace the existing approach to the sharing of profit petroleum from one based on the daily rate of production (DROP) combined with a windfall profits tax imposed when oil prices are higher, to one based on a measure of profitability (r-factor).

Second, under the proposed model PSC, corporate income tax would become tax paid by the company rather than paid out of the government's share of profit oil.

Third, the proposed model PSC proposes to replace the cost recoverability of interest on debt incurred for development costs with a 15% uplift on development spending.

Drop vs r-factor

The first significant difference between the 2008 and proposed fiscal terms is the way in which petroleum production is shared.

As with all production sharing systems, “Cost Oil” is first established to allow the operator to recover its costs.

The remaining “Profit Oil” is split on a sliding scale between the company and the government.

Drop illustration

Production Tranches	Government Share	Company Share
First 20,000 barrels per day	54%	46%
Next 30,000 barrels per day	59%	41%
Next 50,000 barrels per day	65%	35%
Any volumes above 100,000 barrels per day	75%	25%

this traditional sliding scale is based on volume of production and has begun to fall out of favour, as there is no necessary relationship between production volumes and profitability.

Small projects with low costs can generate high profits, while large projects with high costs may not generate much profit.

R-factor

The daily-rate-of-production allocation of profit oil combined with the windfall tax are replaced in the proposed model PSC with an allocation of profit oil based on a direct measure of profitability, an “R-factor.”

An R-factor is essentially the ratio of total project revenues to total project costs. As such, it can be considered a measure of “payback.” When the R-factor is less than 1, total project costs exceed total project revenues. When the R-factor is greater than 2, total project revenues would be more than double total project costs.

R-factor illustration

R-factor	Government Share	Contractor Share
Less than 1	50%	50%
1 to 2.5	60%	40%
Greater than 2.5	70%	30%

The R-factor system would allocate a higher proportion of profit oil to the government as the project becomes more profitable.

It has also been suggested that the R-factor approach would more easily accommodate higher-cost natural gas projects

Corporate tax

According to Clause 27(5) of the PSC "The portion of the Profit Oil or Profit Gas which the Government is entitled to [...] shall be inclusive of all taxes, present or future, based on income or profits of the Contractor, including specifically tax payable under the Income Tax Act, and dividend tax imposed by Kenya on any distribution of income or profits by the Contractor".

Whereas the contractor will still be required to complete income tax returns, they do not actually pay the income tax as reported on these returns. Instead, the tax is "paid" by the government from its share of profit oil. This results in a "deemed" tax that has no impact on company cash flow and generates no additional revenue for government.

The proposed model PSC has a different approach to corporate income tax . In future PSCs, corporate income tax would be “paid” rather than “deemed”.

Clause 39(3) provides “It is understood and agreed that the portion of each category of the Profit Petroleum which the Government is entitled to take and receive for a given fiscal year, and which is calculated under clause 37 shall be exclusive of all taxes payable by the contractor”

Under the terms of the proposed model contract, the Finance Act, 2014 and the new Ninth Schedule on Taxation of Extractive Industries would now be directly applicable to upstream oil companies.

This will add a 30% tax on the contractor’s net income to be paid from the contractor’s share of profit oil.

In addition, companies would be subject to a dividend withholding tax of 10%.

Financing costs

The 2008 model contract for recoverability of financing costs as an investment incentive. The Accounting Procedures (Appendix B) in Section 2.12.2 state “Interest incurred on loans raised by the contractor for capital expenditure in petroleum operations under the contract at rates not exceeding prevailing commercial rates may be recoverable as petroleum costs.”

Risk of abuse – thin capitalisation; profit-shifting in intra-company lending

uplift

The proposed model PSC removes the cost recoverability of interest on borrowing and replaces it with a development cost “uplift”.

The “uplift” is meant to encourage investment by allowing the company to recover an additional percentage of their capital expenditures.

The proposed model PSC states that “An amount equal to fifteen percent (15%) of the development costs” shall be cost recoverable for five years following the approval of a development plan.

This means that the company recovers 115% of their development costs over the first five years.

Conclusion

Common objectives:

- sustainable development
- revenue share
- local content
- technology transfer
- training
- environmental protection