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THE KENYA PETROLEUM ACT 2019: OVERVIEW & ANALYSIS

INTRODUCTION

Kenya discovered commercially viable oil reserves in South Lokichar, Turkana County in 2012, after several decades of exploration dating back to the 1950s. Following the discovery of this precious commodity, the Kenyan Government took up measures to prepare the country for the nascent oil and gas industry.

Among the key areas that the Government sought to restructure was the existing legal and institutional framework for the upstream petroleum industry in Kenya. The sector was mainly regulated by the Petroleum (Exploration and Production Act), 1984 now repealed.

This old law was inadequate for the emerging oil and gas sector and there was also need to align the legal framework to best international practice and the Constitution of Kenya, 2010.For the new Constitution it was particularly important to address new provisions that had arisen from a new system of government through devolution, including how revenues would be shared between the national and devolved governments as well as other provisions touching on Transparency, Land, Environment and Public Benefit.

Evidently a new legal framework has been long overdue for Kenya had lagged behind other emerging producers such as Ghana, Uganda and Mozambique which have already put in place new legislations to manage their emerging oil and gas sectors.

On 13th March 2019, President Uhuru Kenyatta ushered in a new legal framework in both the Petroleum and Energy sectors when he simultaneously assented to the eagerly awaited Petroleum Act (2019) and Energy Act (2019).

The development of this legislation has taken over 7 years due in part to the various new laws that had to be enacted after promulgation of the new constitution but key also, due to the nature and complexity of the subject matter for an emerging producer such as Kenya where capacity and awareness within this sector is still limited.

SALIENT FEATURES OF THE ACT

Consolidation of the entire petroleum value chain in one Statute

The Petroleum (Exploration and Production Act), 1984 (repealed Act) only regulated the upstream petroleum industry whereas midstream and downstream sectors were regulated by the Energy Act, 2006. The enactment of the new Act means that the entire petroleum value chain has now been merged under this single statute.

It becomes the principal substantive law having superiority over other statutes that might have petroleum.

The establishment of the National Upstream Petroleum Advisory Committee

The Act establishes the National Upstream Advisory Committee to advise the Cabinet Secretary in charge of Petroleum. The Committee has membership from the Ministry of Petroleum, National Treasury, and Attorney General's Office, Kenya Revenue Authority, National Environment Management Authority and National Oil Corporation.

The Council of Governors will appoint a nominee to represent the County Governments and the Director-General of Energy and Petroleum Regulatory Authority (EPRA) will sit in the advisory committee as the secretary.

The Committee is allowed to co-opt a member, with necessary knowledge and experience, when necessary to sit in the Committee. However, the members co-opted cannot exceed four members.

This Committee is the key advisory organ on matters upstream to the Cabinet Secretary. Its role extends to formulating criteria for negotiation of petroleum agreements with contractors. The Committee is granted the responsibility to recommend to the Cabinet Secretary on matters related to suspension, revocation and termination of petroleum agreements including recalling any security given under a petroleum agreement.

The establishment of this Committee ushers in the institutionalization of the previously ad hoc National Fossils Fuels Advisory Committee (NAFFAC).

This basically means decision making is no longer a monopoly of the Ministry of Petroleum, but is now encompasses all national government institutions and for the first time, county government representatives.

Establishment of a Regulator

The Act is laudable as it has established a Regulator for the Industry whose role is to regulate, monitor and supervise petroleum operations in Kenya. The current Energy Regulatory Commission (ERC) automatically transitions to the Energy Petroleum Regulatory Authority (EPRA). Key to note is that whereas all matters petroleum are covered in the Petroleum Act, the composition, functions and powers of the Authority are contained in the Energy Act, 2019.

It must be pointed out that this is a unique practice given that in most jurisdictions regulation of the petroleum sector particularly for upstream is separate from other energy sectors. There was an initial proposal during its formulation for a separate upstream regulator but in the final amendments, Parliament instead settled on having upstream regulation within the broader Energy Regulatory Authority.

Therefore, the new Energy Act has established a new body known as the Energy and Petroleum Regulatory Authority which shall need structuring in order to undertake the functions of regulating and managing the upstream sector including developing the requisite capabilities and skills.

Issuance of Petroleum Agreements

The new law gives clarity on the award process for petroleum exploration licenses which will now be through both a competitive bidding process and direct negotiations in certain instances. However, both will follow specific bidding guidelines as stipulated in the new law.

The competitive bidding process is popular industry practice that ensures transparency in award of exploration acreage and secures the best investors for oil and gas exploration in the country. It is also consistent with the Procurement laws and principles of good governance as provided for by the Constitution of Kenya.

In the spirit of transparency, the new law prescribes that for any award, the Cabinet Secretary shall be required to invite bids for any oil blocks and it lays out the process of awarding these blocks through a licensing round.

The new law however also provides that the Cabinet Secretary can conduct direct negotiations in the following exceptional circumstances; where there are no bids received; the bids received do not satisfy the minimum criteria; or where there is insufficient data in relation to a block.

It important to note that even where there is direct negotiations, section 18 of the Act is elaborate on how this should be conducted. The government can also set aside oil blocks for the national government.

The new Act also attempts to deter or lock out speculators by stating that contractors bidding for any acreage are required to prove they have the technical and financial capability to fulfil any work obligations.

Ratification by Parliament

Another big milestone is the provision by the new Act requiring ratification of the Production Sharing Contract (PSC) and Field Development Plan (FDP) by Parliament.

The repealed Act was silent on disclosing of the contents of the PSC but instead provided a template of what a PSC would look like. It would seem that the ratification will only happen where there is a commercial discovery because the Act requires that the Production Sharing Contract (PSC) be submitted together with the Field Development Plan (FDP).

The FDP comes into play only where there is a discovery of oil and is used to determine the optimum way of developing and producing a discovery.

This though begs the question whether the intent of ratification as envisioned in the Constitution is fully met. On the upside, this is good for investors as they would not be saddled with a long parliamentary process and there is certainty during the negotiation phase.

Overhaul of the Profit Sharing Mechanism

On fiscal terms, the new law introduces some significant changes, with the most significant being a departure from a volume based profit sharing mechanism, to a profitability based mechanism commonly referred to as R-Factor.

In the repealed 1984 Act (Appended Model Production Sharing Contract), the sharing of profits between the government and the International Oil Companies (IOC's) was based on daily rate of production through a sliding scale.

At lower levels of daily production, the Government would get a certain percentage share of profit, which would increase on the higher production tranches. The IOC would start with a higher profit share rate, which reduces with increased production.

The R-Factor mechanism calculates a ratio of cumulative revenues over cumulative costs. The ratio reaches 1 when cumulative revenues equal cumulative costs, and signals a "break-even" point for the project. Above the ratio of 1, the Government share of profits starts to increase.

This new mechanism will apply to future contracts, but existing investors will be free to adopt it in the existing agreements if they so choose. The R-Factor mechanism can be applied to both oil and gas projects, and cures an important gap that was in the old model production sharing contract which did not have gas terms.

The shift from a volume based mechanism to a profit based mechanism underscores the need for Government to build more capacity to monitor revenues and costs, as these will have a direct impact on profit share. The shift however accommodates marginal fields, which would have otherwise not been developed owing to the low volumes.

Taxation

The new Petroleum Act contains a significant departure from the old law on taxation. In the old law, Profit share to Government was deemed to include its share of taxes right from the contract negotiation.

This implied that an investor would not have any further obligation with regards to Corporate Tax as the Government would "Pay on its behalf" Under the new law, IOCs will be liable to pay Corporate Income taxes out of their share of profit oil.

This essentially means the IOC's will negotiate higher profit share percentages, and the Government share will be lower. In terms of value, the Government share of benefits will remain as before, but the obligation to pay tax will shift to the IOC's.

This fundamental change will have important ramifications to the Kenya Revenue Authority. It will need to build more capacity to understand and monitor the operations of IOC's.

The additional administrative burden will also pose a risk of tax leakage in a situation where an IOC holds one PSC under the old "Pay-on-behalf" mechanism and a second PSC under the new law that carries a tax obligation. Taxation

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Mathematically speaking, the Government share of benefits will remain same as before, but the obligation to pay tax will shift to the IOC's. This fundamental change will have important ramifications to the Kenya Revenue Authority. It will need to build more capacity to understand and monitor the operations of IOC's.

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Transparency

The Act requires that any entry to a petroleum agreement by the National Government be conducted in a fair, equitable, transparent, competitive and cost effective manner.

The Cabinet Secretary is required to develop a framework for reporting, transparency and accountability in the upstream petroleum sector which includes publication of all petroleum agreements.

Environment, Health and Safety

Environment health and safety is indispensable in the petroleum industry. It is commendable to see that the Act has comprehensively addressed this in 13 sections.

It delves into detail on issues of occupational safety, environmental compliance, waste management, property maintenance, venting and flaring, reporting accidents, emergency preparedness and pollution.

In keeping with international best practices, the Act has introduced a Decommissioning Fund in which all contractors are bound to contribute to in order to deal with post exploration environmental and health rehabilitation activities, among others.

Revenue Sharing

Revenue sharing was the most contentious political issue that contributed to the delay in enactment of the Act. The National and County Governments reached a consensus in 2018 on formula for sharing petroleum revenues and this has been included in the Act.

It has been heralded as a big win for the County Governments and local communities who will now benefit from resources within the Counties. The revenue that the Government receives shall be apportioned between the National Government, County Government and Local Community at a ratio of 75%, 20% and 5% respectively.

Fiscal Obligations

The Act introduces a compulsory Signature bonus that a contractor is required to pay to the National Government. The amount is not fixed and is subject to negotiations according to the Model Production sharing contract. The contractor will also pay the annual fees, training fee and surface fee which are also subject to negotiation.

Local Content

Local content is the bedrock for any country or State drawing maximum value for its natural resources. In this regard Kenya will realise greater benefit by leveraging local content than from the direct revenue generated from the resources.

The provisions on local content in the Act are generic probably because of a comprehensive Local Content Bill currently before Parliament. The Act has retained the Training fund for training Kenyans in upstream petroleum operations.

Community Rights

The Act appreciates the integral role of the community in petroleum operations and has provided for an array of rights including right to prior information, compensation, education and participation for planning of Corporate Social Responsibility projects.

The Energy and Petroleum Tribunal

The Act is categorical on disputes between parties in a petroleum agreement being resolved through Alternative Dispute Resolution. Disputes arising out of upstream regulatory functions shall go through the Authority at first instance.

The Tribunal has appellate jurisdiction over decisions of the Authority and any licensee in midstream and downstream petroleum operations. The Tribunal shall have original civil jurisdiction on disputes arising out of the bidding rounds as well as disputes between licensees and third parties.

The Act nominates the Energy and Petroleum Tribunal which is governed under the Energy Act, 2019.

Segmentation

The Petroleum Act introduces segmentation which requires a contractor conducting upstream activities not to have any proprietary interest or control in any downstream operations. Subsequent provisions however provide that subsidiary companies to the contractor may participate in midstream and downstream activities.

This provision in our view will particularly support the National Oil Company as it seeks to grow its footprint across the petroleum value chain.

OTHER KEY PROVISIONS

- Penalties – The Act introduces a raft of offences and heavy penalties going as high as a fine of 100 Million or ten year imprisonment or both. The major offences include operating without licenses/permits and those to do with activities that are destructive to environment.

- Introduction of Natural Gas Provision - the Act provides for the development and utilization of associated natural gas.

- Use of land for petroleum operations – The Act provides that access to land shall be in accordance with the Constitution and the relevant land laws. It requires operators to obtain consent from land owners and provide compensation for the use of the land. It also provides for compulsory acquisition by the government for upstream activities.

- Indemnity- the Act requires the contractors under a petroleum agreement to keep the National Government indemnified against all actions, claims and demands that arise in the course of their explorations.

- Sharing of infrastructure – Provided there are no significant technical challenges, the Act requires owners of upstream and midstream infrastructure to provide access to third parties under reasonable condition.

IMPLEMENTATION OF THE ACT

The Cabinet Secretary is required to develop and publish a National Petroleum Policy. This Act is quite onerous as it requires enactment of over 40 regulations for its implementation.

These include procedures for bidding, award of oil blocks and direct negotiations, fees, unitization, registration of contractors, licensing, local content and transparency.

TRANSITION

The Act preserves all contractual rights and obligations granted in the previous Act and deems them to have been done in this Act. This is an important clause to re-assure existing investors on the sanctity of signed contracts.

However, there will be need for interpretation on areas where the new law imposes higher thresholds for compliance by holders of existing contracts.

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CONCLUSION

The new Petroleum Act is transformative and a much needed development to the petroleum industry. It clearly defines the roles of stakeholders and will hopefully spur investment. However, it is onerous as it requires numerous regulations to be implemented. Further, it requires tidying up because of inconsistencies which stemmed from the initial proposal to have an independent regulator which provision has since been abandoned and its role assigned to the Energy and Petroleum Regulatory Authority.

It is our opinion that had the law emanated from a policy, some of the challenges would have been avoided. There is therefore need to fast track ongoing efforts towards development of a petroleum policy.

We also observe a limitation in clearly defining the role of the National Oil Company (NOC) in the new law which while delving greatly on the policy role of the Cabinet Secretary and the regulatory role of the Energy and Petroleum Regulatory Authority, speaks very little on the commercial role to be played by the National Oil Company which is the other key institution in the sector.

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Ms. Doris Mwirigi is the Managing Director of Energy Solutions Africa (ESAL Africa), a leading African focused advisory firm that offers solutions to key players in the oil, gas and power sectors. She is a seasoned and accomplished Energy Professional with over fifteen (15) years' experience in Energy Law and Energy Advisory at a corporate level, both locally and internationally. Ms. Mwirigi has been involved in notable oil and gas projects in the region including Kenya, Rwanda, Uganda and Somalia. In particular she has advised on policy development, negotiation and transactions.

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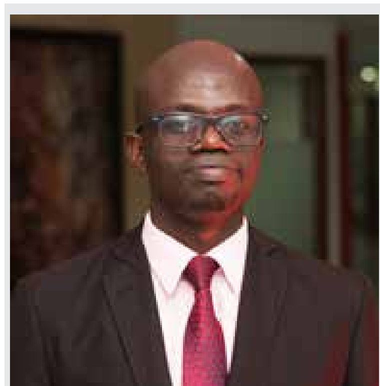

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