



# EXAMINING THE CRUDE DETAILS

Government Audits of Oil & Gas Project Costs  
to Maximize Revenue Collection

*Kenya Case Study*

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Kenya is new to the petroleum sector: its first oil project began an “early oil pilot scheme” in 2018. The country aims to lay the groundwork for effective cost auditing, but it is not easy. Kenya lacks petroleum-sector experience, proposed changes to the fiscal regime and regulatory institutions leave mandates and coordination uncertain, and undisclosed contracts with reported fiscal stabilization clauses make it difficult for the public to understand the potential revenues projects could generate. Still, Kenya’s decision to hire external experts to assist with the first cost recovery audit is a promising partial solution to the challenge of ensuring a rigorous audit and building government capacity. In the future, it should start audits sooner, and embrace transparency—disclosing contracts, technical assistance reports, and cost audits.

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Cover photo: Absent a pipeline, oil in Kenya is moved by trucks in a costly transport scheme.

# OIL AND GAS PROFILE

Kenya is the newest oil producer out of the three case study countries. It was 2012 when the first commercially viable oil discovery was made in the Lokichar subbasin by Tullow Oil. To date, more than 86 wells have been drilled, most within the Tertiary Rift. Tullow Oil estimates that the Lokichar subbasin contains more than 4 billion barrels of crude oil reserves and an estimated 750 million barrels of recoverable oil.<sup>1</sup> Early oil production began in June 2018, and “first oil” is expected in 2021–2022.<sup>2</sup>

## AUDIT SNAPSHOT



		Kenya
Petroleum Sector Context	<b>Fiscal regime type</b>	Production-sharing regime
	<b>Contract type</b>	Production-sharing contracts (PSCs)
	<b>Year of first oil production</b>	2018: Blocks 10BB and 13T: (Tullow Oil)
	<b>Number of PSCs</b>	Production: 2 PSCs (early oil) Exploration/pre-development: 10 PSCs. <sup>3</sup>
Utilization of Cost Audit Rights	<b>Number of petroleum fiscal audits</b>	<i>Cost recovery audit:</i> 2 PSCs (Blocks 10BB and 13T; Tullow Oil), started in 2018  <i>Field-based tax audit:</i> 2 PSCs per year (2014–2018)  <i>Desk-based tax audit:</i> All active PSCs annually (2014–2018)
	<b>Audit results from the start of production</b>	<i>Tax audit:</i> \$50 million expected for 2012–2015 (assessment yet to be issued)  <i>Cost recovery audit:</i> \$0



## LAWS

### Cost-auditing rights

Two sources of law govern cost-auditing rights in Kenya:

- Article 30(3) of the Model Petroleum Sharing Contract (PSC) (2008) gives the government (represented by the Ministry of Petroleum and Mining) the right to audit the financial information of the contractor within two calendar years of the period to which they relate. It also gives the Minister the right to request that the contractor appoint an independent auditor of international standing, approved by the government, to audit the financial information of the contractor annually. The cost of the audit shall be borne by the contractor and be cost recoverable. The new Petroleum Bill (2017) and accompanying Model Petroleum Agreement increase the time period for cost recovery audit to eight years and transfer audit responsibilities to the Upstream Petroleum Regulatory Authority (UPRA).<sup>3</sup>
- The Ninth Schedule of the Kenya Income Tax Act (1974) gives the Kenya Revenue Authority (KRA) the right to assess taxes owed by petroleum companies up to seven years after the year income to which the assessment relates (some exceptions apply). Generally, Part IX of the act gives the KRA the power to inspect goods and records, to demand records from taxpayers, to search and seize, etc.

### Eligible costs

The sources of law that dictate eligible costs are the same as those listed above. The Model PSC (2008), to be replaced by the Model PSC (2017), sets out the recoverable costs, and the Ninth Schedule of the KRA determines the tax-deductible costs, although these have been less relevant under the “pay-on-behalf” corporate income tax (CIT) system.

Until now, costs have been aligned between cost recovery and income tax regulations, but the new Model PSC (2017) no longer classifies interest expense as cost recoverable (although it remains tax deductible). It also introduces a 15 percent uplift on development spending for five years following the approval of a development plan (i.e., investors can recover 115 percent of costs over the first five years).<sup>4</sup> (See the table that follows for a summary of important proposed changes to the petroleum fiscal regime.) Within production-sharing systems, it is relatively unusual for interest expense to be cost recoverable, so this change will bring Kenya’s petroleum fiscal regime in line with best practice. With respect to the uplift, UPRA will need to monitor development expenditure to ensure that the contractor does not overstate costs in light of the tax benefit. corporate income tax will also be calculated separately in accordance with corporate income tax regulations and paid directly by the company, making tax deductions much more relevant. The KRA will also need a



more rigorous system for auditing costs.

### Proposed Changes to Kenya’s Petroleum Fiscal Regime

Fiscal Instrument	Model Petroleum Agreement 2008	Model Petroleum Agreement 2017 (not yet in force)
<b>Corporate income tax</b>	Pay on behalf: the government pays the contractor’s corporate income tax from its share of profit oil.	Direct payment: corporate income tax will be calculated separately in accordance with regulations (see S.5 of the Ninth Schedule of Cap. 470 for a list of eligible deductions) and paid directly by the company.
<b>Withholding tax on dividends</b>	Included in the pay-on-behalf scheme.	Standalone revenue stream.
<b>Profit sharing</b>	Sharing is based on production volumes; the maximum state share is achieved when production exceeds 100,000 barrels per day.	Sharing is based on profitability (i.e., total project revenues minus costs). The effective government take increases as the project’s rate of return increases.
<b>Interest expense</b>	Cost recoverable (as well as tax deductible under Cap. 470).	No longer cost recoverable; replaced by a 15 percent uplift on development spending. Interest expense remains tax deductible under Cap. 470.
<b>Limit on cost oil</b>	Capped at 60 percent.	Limit is negotiable.

In principle, the proposed Petroleum Bill (2017) and corresponding Model PSC (2017) will apply only to new companies. According to the Ministry of Petroleum and Mining, the spirit of the bill is to protect existing companies from changes to the legal and fiscal framework. But there may be transition requirements with which existing companies are required to comply—for example, procedural reforms (e.g., the establishment of UPRA as the industry regulator). Tullow says it has economic stabilization clauses in its PSCs, although this cannot be verified as the agreements are not public.

## **Penalties**

There are no special tax penalties for the petroleum sector. There are a range of penalties for failure to file returns, register, keep records, and submit documentation. For late payment of tax, the penalty is 20 percent of the amount. For tax shortfalls resulting from false or misleading statements, the penalty is between 20 and 75 percent of the tax shortfall. For tax avoidance schemes, the penalty is double the tax avoided.<sup>5</sup>

## **Safeguards for taxpayers**

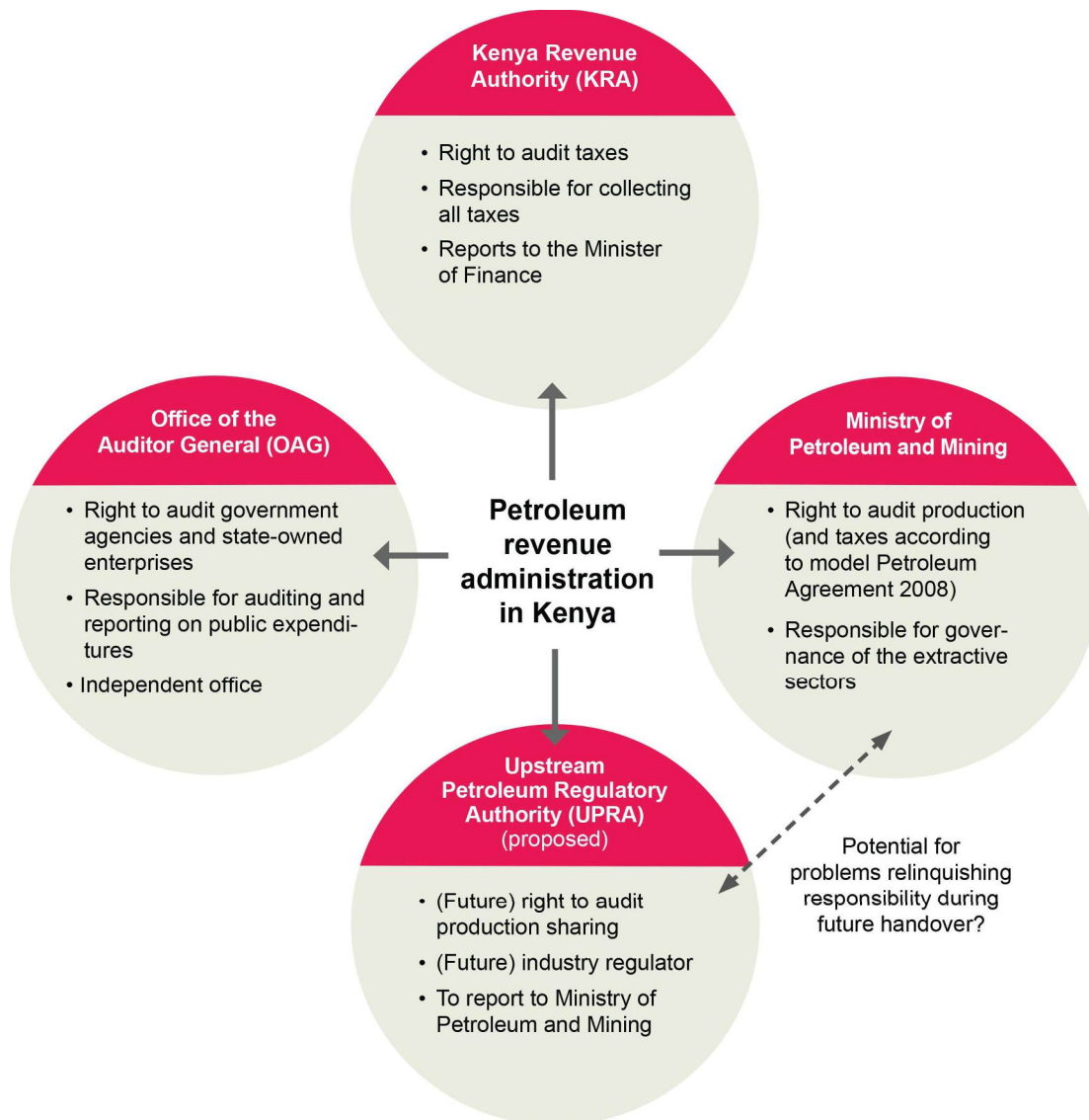
Part VIII of the Tax Procedures Act (2015) provides that a taxpayer can contest assessments issued by the KRA. First, a taxpayer may submit a formal objection to a tax decision to the commissioner. If the taxpayer is not satisfied with the resulting decision regarding the objection, it may appeal the decision to the Tax Appeals Tribunal. Beyond the Tax Appeals Tribunal, the taxpayer may file further appeals to the High Court of Kenya and the Court of Appeal.



# COORDINATION

Two government agencies (the Ministry of Petroleum and Mining and the KRA) are responsible for cost auditing. The Office of the Auditor General (OAG) is responsible for overseeing the audit functions of these two agencies.

## Petroleum revenue administration in Kenya



The Ministry of Petroleum and Mining is in charge of formulating and enforcing policies for the petroleum sector. It oversees upstream, midstream, and downstream activities. Under the Model PSC (2008), the ministry is responsible for cost-recovery audits. It recently contracted external consultants to assist with a cost-recovery audit of Blocks 10BB and 13T. It is also responsible for approving companies' work programs



and budgets. According to the proposed Petroleum Bill (2017), these functions will transition to the UPRA once it is established, along with the responsibility for issuing licenses.<sup>6</sup> UPRA will also manage a national data center for storage, analysis, interpretation, and management of petroleum data on behalf of government. A smooth transition will be important.

The KRA is mandated to collect all petroleum taxes. To date, these have been limited to payroll taxes and indirect taxes (e.g., value-added tax). Moving forward, they will include CIT, which will make the KRA a much bigger player in petroleum revenue administration than under the pay-on-behalf corporate income tax regime. Initially, the KRA thought its role included carrying out cost-recovery audits.<sup>7</sup> It was subsequently convinced that this was the job of the ministry and proposed coordination of audit results instead. According to companies, cost-recovery auditing is solely the responsibility of the ministry.<sup>8</sup> The KRA raises questions related to cost recovery, in particular the level of costs (e.g., drilling consultancy rates), which, according to the companies, it does not have the expertise to verify.

The OAG aspires to be directly involved in cost-recovery audits. It suggests its constitutional mandate to audit and report on public expenditures includes cost recovery. It plans to build its capacity to carry out cost-recovery audits, starting with attending upcoming International Monetary Fund (IMF) workshops on the oil and gas industry.<sup>9</sup> While effective oversight of the ministry and KRA's audit obligations is necessary, the OAG should not seek to replicate cost audits; it has limited knowledge of the petroleum sector and would be duplicating efforts elsewhere.

The National Oil Company of Kenya (NOCK) was set up in 1981 with a mandate to participate in all aspects of the petroleum industry. The NOCK is wholly owned by the Government of Kenya through joint ownership by the Ministry of Petroleum and Mining and the National Treasury. Currently, it focuses on downstream activities. However, recognizing the importance of controlling costs, the NOCK previously requested that the ministry allow it to conduct a cost-recovery audit of the Tullow project.<sup>10</sup> The ministry agreed, but in the end the process was stalled because it would not grant the NOCK the funds to carry out the audit.



## CAPACITY

### **Staff numbers and expertise**

The oil, gas, and mining unit at the KRA has six staff members. With 10 active PSCs, this is roughly 2 staff people per license, which is on par with emerging economies.<sup>11</sup> The unit has received training from the IMF, World Bank, the Norwegian Agency for Development Cooperation

(NORAD), and the Australian government.<sup>12</sup> The focus has been on increasing understanding of the oil and gas business, although the KRA says it now needs training on specific aspects of petroleum taxation.<sup>13</sup> Moving forward, the emphasis will be on risk assessment. The World Bank is supporting a consultant to work with the KRA to develop a risk matrix for the petroleum sector. It is also funding the development of a database to which oil companies will be able to upload real-time data to enable trend analysis.<sup>14</sup>

In the interim, as the government develops its cost-auditing expertise, it has chosen to co-source external audit expertise. The Ministry of Petroleum and Mining has recruited a group of external consultants to carry out the first cost-recovery audit of Tullow Oil in relation to Blocks 10BB and 13T. The ministry chose this approach because it wants to build capacity in house rather than outsource to an independent, external auditor.<sup>15</sup> The terms of reference explicitly require the consultants to build government auditing capacity and develop audit processes while undertaking the audit. The World Bank is providing a loan of about \$500,000 to the ministry to cover the cost of the consultants.<sup>16</sup> The loan is expected to be repaid by the government.

## Risk-based audit strategy

The oil, gas, and mining unit is part of the Large Taxpayers Office, which is in the KRA's Domestic Tax Unit. The KRA has an annual audit plan that requires the oil, gas, and mining unit to conduct two intensive tax audits per year (these audits are comprehensive and on site, involve collaboration with the international tax unit in some instances, and usually last two months).<sup>17</sup> It also conducts single-issue audits, specifically on payroll taxes, which have been problematic owing to different interpretations; and annual desk-based audits.<sup>18</sup> The transfer-pricing issues they have encountered relate mainly to the fees charged for technical services.<sup>19</sup>

The general risk assessment process is defined in the KRA's audit manual, but the oil, gas, and mining unit plans to develop a specific risk matrix for the oil sector with support from the IMF and the World Bank-funded Kenya Petroleum Technical Assistance Program (KEPTAP) program.



## INFORMATION

The Tax Procedures Act (2015) requires taxpayers to maintain any document required under a tax law so as to enable the KRA to assess the taxpayer's liability. Section 23 of the act specifies that records must be kept for five years from the end of the reporting period to which they relate. The Model PSC (2008) also requires companies to maintain financial accounts in accordance with the accounting procedure set out in the PSC. The company must provide the ministry with the accounts, as well as a description of accounting classifications.

The international tax unit at the KRA also has access to the Bureau Van Dijk transfer-pricing database (Orbis), which it shares with the oil, gas, and mining unit as required. The latter finds the database useful in enforcing tax compliance.<sup>20</sup> For example, the unit wanted to know why charges for technical services in the upstream oil and gas industry were so high. The international tax unit provided the data to determine whether the charges were arm's length or comparable to charges that would take place between unrelated parties.<sup>21</sup> The issue has yet to be resolved, but the companies know that the KRA has access to credible data and as a result are becoming more careful to provide detailed descriptions of costs, thus setting the tone of the relationship moving forward.



## TIMEFRAME

Kenya provides examples of good and bad timing in auditing. The Ministry of Petroleum and Mining began its first cost-recovery audit of Tullow Oil in 2018.<sup>22</sup> The two-year time limit means that only costs from 2016 and 2017 can be audited, whereas the \$1.8 billion Tullow spent between 2008 and 2016 cannot be audited, even though the company will still be able to recover those costs in subsequent years. This situation has impacts on government revenue. However, the ministry nonetheless requested to review costs from before 2016, and Tullow agreed,<sup>23</sup> though the company may still try to reject adjustments for years prior to 2016.

The KRA has been auditing petroleum costs for much longer despite there being no corporate income tax to collect. It has shown considerable foresight, especially as it transitions to direct payment of corporate income tax under the proposed Petroleum Bill (2017).<sup>24</sup> According to a senior official, "There are things you do that have a long-term impact. If [we] don't straighten issues out at this stage, the country will run into serious headwinds in the future. [We] need to ensure that government's share is correct."<sup>25</sup> The KRA's timeliness is unusual. It is more common to see developing-country tax authorities start to audit costs only when corporate income tax begins to flow.



## ACCOUNTABILITY

### National Oil Company of Kenya

The NOCK is audited by the OAG on a regular basis. The last audit report available on the website is from 2016.<sup>26</sup> It is treated as a regular taxpayer insofar as paying taxes on the income from its downstream activities. As such, it is also liable to a tax audit by the KRA. In the future, if the NOCK participates in upstream activities as either an operator or a joint venture partner, it is not expected to be treated any differently from a private oil company.<sup>27</sup>

## Oversight institutions

The OAG has been active in monitoring the performance of the government institutions involved in managing the petroleum sector. According to a civil society representative, “The Auditor General is one of the few outspoken agencies with respect to public funds.”<sup>28</sup> In particular, it has raised concerns regarding failure of some PSCs to conform to law, the spending of the petroleum training levy, and payment of signature bonuses.





Civil society has expressed reservations about the parliamentary committee on energy’s private meetings with the international oil companies in relation to the proposed Petroleum Bill.<sup>29</sup> There is concern that some terms proposed for inclusion in the bill may instead be pushed into the Model PSC. This change means that instead of the terms being defined by law, international oil companies and government actors would have the discretion to negotiate these terms for each new project—an arrangement that may favor companies seeking project-specific benefits or incentives. Civil society has also expressed concern about the parliamentary committee’s ability to play an effective oversight role given its limited knowledge of the sector, although the ministry does provide back-stopping support.<sup>30</sup>

## Contract disclosure

The Kenyan Government has signed at least 44 contracts with oil and gas companies.<sup>31</sup> Of these contracts, only 10 have been made public.<sup>32</sup> The lack of disclosure of contracts denies a key oversight mechanism. While Tullow Oil has expressed support for contract disclosure,<sup>33</sup> the government refuses to take this step. It has also declined to join the Extractive Industry Transparency Initiative.

# RECOMMENDATIONS



	Recommendation	Responsible Actor
 <b>LAWS</b>	Limit the time and scope of fiscal stabilization provisions, if the ministry chooses to provide such assurances in future PSCs. It should also expressly <i>exclude</i> the application of stabilization clauses to regulatory changes relating to audit powers.	Ministry of Petroleum and Mining
 <b>COORDINATION</b>	Conduct joint audits. By combining their respective expertise, both agencies could the accuracy of fiscal audits. However, if joint audits are not feasible, there should at least be reconciliation of audit results between the two agencies.	Ministry of Petroleum and Mining, KRA
	Monitor the transfer of responsibilities for cost-recovery auditing from the Ministry of Petroleum and Mining to EPRA, once the latter is established. The distinct roles and responsibilities of both agencies should be clearly established in the regulations; EPRA should have adequate budget, personnel, and training to do its job.	Civil society
 <b>CAPACITY</b>	Ensure that both agencies have adequate staff and expertise to effectively assess risk and audit costs under the new Petroleum Bill [2017]; the 15 percent uplift on development expenditure and direct payment of CIT may prompt more aggressive tax planning than under the old regime.	Ministry of Petroleum and Mining, KRA
	Make reports of technical assistance provided to the Kenyan government publicly available, so that stakeholders, including other technical assistance providers, can better understand the support that has been given.	International development partners
 <b>INFORMATION</b>	Give the KRA (and other relevant agencies) unfettered access to the Commercial Database and Upstream Integrated Economic Planning System once it is developed. The database will be essential for risk assessment and auditing.	Ministry of Petroleum and Mining

 <b>TIMEFRAME</b>	<p>Start cost-recovery audits sooner and conduct them more frequently; otherwise the ministry risks not being able to review costs that have fallen outside the legal timeframe for audit or request the corresponding records.</p>	<p>Ministry of Petroleum and Mining</p>
	<p>Respond quickly and cooperatively to government requests for auditing information, including for information about exploration and development expenditures from prior years.</p>	<p>Oil and gas companies</p>
 <b>ACCOUNTABILITY</b>	<p>Publish audits an annual report on petroleum revenues, including aggregated information on cost-auditing activities and results.</p>	<p>KRA</p>
	<p>Continue to build technical knowledge of the petroleum sector in order to effectively monitor the cost auditing functions carried out by the KRA and the ministry. However, the OAG should not undertake cost-recovery audits itself, as this would lead to duplication of effort and complicate the lines of accountability.</p>	<p>OAG</p>
	<p>Publish all PSCs including Tullow Oil's.</p>	<p>Ministry of Petroleum and Mining, oil and gas companies</p>
	<p>Join the Extractive Industry Transparency Initiative, or establish a similar national framework.</p>	<p>Ministry of Petroleum and Mining</p>
	<p>Prioritize stakeholder consultation—including civil society—and enactment of the Petroleum Bill (2017).</p>	<p>Parliament</p>
	<p>Cooperate with government to publish audit activities and results, starting from the first cost audits undertaken in the sector. It is in the interest of oil and gas companies to show that they are regularly audited by government and that specific concerns raised by the public, such as transfer pricing, are being addressed.</p>	<p>Oil and gas companies</p>



# NOTES

- <sup>1</sup> Tullow Oil, *2017 Full Year Results* (London, 2018), p. 1, [https://www.tullwoil.com/Media/docs/default-source/3\\_investors/2017-full-year-results/tullow-oil-plc---2017-full-year-results-statement-final-updated-2.pdf?sfvrsn=18](https://www.tullwoil.com/Media/docs/default-source/3_investors/2017-full-year-results/tullow-oil-plc---2017-full-year-results-statement-final-updated-2.pdf?sfvrsn=18)
- <sup>2</sup> Ibid.
- <sup>3</sup> Republic of Kenya, The Petroleum (Exploration, Development and Production) Bill (2017), draft version as introduced in the National Assembly December 6, 2017 (Kenya Gazette Supplement No 186 (National Assembly Bills No 48) [hereinafter "Petroleum Bill (2017)"], Art. 43.4. The Petroleum Bill (2017) suggests this institution will be the Upstream Petroleum Regulatory Authority (UPRA). However, there are some suggestions that UPRA may in fact be replaced by an authority with a different name, the Energy and Petroleum Regulatory Authority (EPRA), including its reference in another proposed bill, The Energy Bill (2017). This bill was published in the Kenya Gazette Supplement No. 194 of 2017 and passed by the National Assembly, with amendments, on June 7, 2018.
- <sup>4</sup> Compare Sections 36 and 43.4 in Model PSC (2017) with their counterparts in the Model PSC (2008).
- <sup>5</sup> BDO Kenya, Income Tax Penalties, 2018, <https://www.bdo-ea.com/en-gb/microsites/doing-business-and-investing-in-kenya/tax/page-elements/taxation-in-kenya/income-tax-penalties>
- <sup>6</sup> Petroleum Bill (2017) Art. 16.
- <sup>7</sup> Interview with civil society petroleum sector expert, April 23, 2018; interview with Kenya Revenue Authority, April 25, 2018.
- <sup>8</sup> Interview with multinational company involved in oil projects in Kenya, April 12, 2018.
- <sup>9</sup> Interview with civil society petroleum sector expert, April 23, 2018; interview with Kenya Revenue Authority, April 25, 2018.
- <sup>10</sup> M. Kamau and O. Guguyu, "Why Tullow Is Holding All the Cards in Oil Exploration Deal with State," *Standard Digital*, March 28, 2017, <https://www.standardmedia.co.ke/business/article/2001234303/why-tullow-is-holding-all-the-cards-in-oil-exploration-deal-with-state>
- <sup>11</sup> J. Calder, *Administering Fiscal Regimes for Extractive Industries* (Washington, DC: IMF, 2014), p. 62, <http://eduart0.tripod.com/sitebuildercontent/sitebuilderfiles/AdministeringFiscalRegimesForEI.pdf>
- <sup>12</sup> Interview with Kenya Revenue Authority, April 25, 2018.
- <sup>13</sup> Ibid.
- <sup>14</sup> World Bank, Kenya Petroleum Technical Assistance Project (KEPTAP). Projects and Operations (Washington, DC, 2016), <http://projects.worldbank.org/procurement/noticeoverview?id=OP00038439&lang=en&print=Y>; interview with Ministry of Petroleum and Mining, 23 April 2018.
- <sup>15</sup> Ibid.
- <sup>16</sup> World Bank, Kenya Petroleum Technical Assistance Project (KEPTAP).
- <sup>17</sup> Interview with Kenya Revenue Authority, April 25, 2018.
- <sup>18</sup> Ibid.
- <sup>19</sup> Ibid.
- <sup>20</sup> Ibid.
- <sup>21</sup> Ibid.
- <sup>22</sup> A. Mbogo, "Petroleum Ministry Begins Audit of Tullow Oil's Expenses in Turkana," *Kenyan Wall Street*, June 7, 2018, <https://kenyanwallstreet.com/petroleum-ministry-begins-audit-of-tullow-oils-expenses-in-turkana/>
- <sup>23</sup> Interview with Tullow Oil, April 12, 2018.
- <sup>24</sup> Kenya Petroleum Bill (2017) Art. 39(3).
- <sup>25</sup> Interview with Kenya Revenue Authority, April 25, 2018.
- <sup>26</sup> Office of the Auditor General, Report of the Auditor-General on the Financial Statements of National Oil Corporation of Kenya Limited (2016), [http://www.oagkenya.go.ke/index.php/reports/cat\\_view/2-reports/9-national-government-and-state-corporations/8-state-corporations/252-2015-2016?start=150](http://www.oagkenya.go.ke/index.php/reports/cat_view/2-reports/9-national-government-and-state-corporations/8-state-corporations/252-2015-2016?start=150)
- <sup>27</sup> The National Oil Company of Kenya (NOCK) declined to respond to interview requests for this study.
- <sup>28</sup> Interview with civil society organization in Kenya, April 23, 2018.
- <sup>29</sup> Interview with civil society organization in Kenya, May 3, 2018.
- <sup>30</sup> Interview with civil society organization in Kenya, April 23, 2018.
- <sup>31</sup> M. Kamau, "Civil Society Pushes for Amendments to Petroleum Bill to Open Up Contracts," *Standard Digital*, April 3, 2018, <https://www.standardmedia.co.ke/business/article/2001275414/lobbies-want-oil-contracts-now->

made-public; Kenya Civil Society Platform on Oil and Gas, Disclosure of Petroleum Contracts, May 5, 2017, <https://kcspog.org/disclosure-of-petroleum-contracts/>

<sup>32</sup> Kamau, "Civil Society Pushes for Amendments to Petroleum Bill to Open Up Contracts."

<sup>33</sup> Oxfam, *Contract Disclosure Survey 2018* (Oxford: Oxfam, 2018), <https://www.oxfam.org/en/research/contract-disclosure-survey-2018>



Photo: Residents walk under trees in Turkana, a remote region in western Kenya undergoing major oil exploration and extraction (Kieran Doherty / Oxfam Great Britain).

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