MAPPING RISKS TO FUTURE GOVERNMENT PETROLEUM REVENUES IN KENYA

A FRAMEWORK FOR PRIORITIZING ADVOCACY, RESEARCH AND CAPACITY BUILDING

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INTRODUCTION

The loss of government revenue due to tax avoidance/evasion strategies by multinational companies has received significant attention in recent years in both developed and developing countries. It is widely accepted that the extractive sector is particularly vulnerable to tax evasion. Kenya has the opportunity to benefit from the lessons learned in other jurisdictions in order to maximize the revenue benefits it receives from oil and natural gas. This paper seeks to provide a framework for assessing the risk of potential revenue loss and prioritizing possible responses.

The analysis below is based on four different sources of information. First, the research focused on the existing legal framework and production sharing contracts. Although a new Petroleum Law and model production sharing contract are currently under review, it is the existing production sharing contracts that will determine potential government oil revenue in the coming years. A second key source of information was the growing body of literature on the challenges of tax administration in the extractive sector.[1] Third, case studies have been used, where possible, to illustrate the risks that governments, developed and developing, face in trying to secure a fair share of extractive sector revenues. Finally, estimates of the potential scale of revenue loss have been generated from an economic model developed to forecast potential government revenues from Turkana oil.

THE CHALLENGES OF TAX AVOIDANCE/EVASION

Concern about tax avoidance and evasion has been growing in recent years in both developed and developing countries. There are some common sets of challenges that affect all countries and all sectors including treaty shopping, transfer pricing and the use of tax havens and low tax jurisdictions. Ultimately, however, the threats to government revenue from tax avoidance measures are sector-specific, and sometimes even project-specific.

There is no doubt that the extractive sector is particularly vulnerable to tax evasion strategies. But as the text box below illustrates, there some characteristics of petroleum and mining that increase vulnerability to revenue loss and other characteristics that decrease vulnerability.[2]

Securing a fair share of government revenue from extractive sector projects is a two-step process: establishing a fair tax *rate* for the project at the outset, and then protecting the tax *base* over the lifespan of the operation. Shortcomings on either front can result in significant loss of government revenue.

Textbox: Extractive Industries Revenue Risks

Factors increasing vulnerability to government revenue loss include:

- large scale extraction undertaken by foreign owned multinationals;
- operations financed with foreign capital;
- highest value goods/services are imported;
- goods and services are provided by intra-firm management and service companies;
- high rates of taxation increase incentives for profit shifting.

Factors reducing vulnerability to government revenue loss include:

- commodities not "branded" products, they can be physically weighed and measured;
- prices for most commodities are quoted on international exchanges;
- costs normally involve genuine operations and expertise rather more nebulous concepts such as intellectual property.

Establishing the Tax Rate

The tax terms that should determine the proportion of extractive sector project revenue allocated to the government are normally set out in both project-specific contracts (host country agreements) as well as national tax and investment laws and regulations.

The sources of government revenue from extractive sector projects are often different than for normal businesses. In the mining sector, the mix of fiscal instruments commonly includes royalty payments, corporate income tax (and increasingly a windfall or "resource rent" tax). In the petroleum sector, a production sharing system is common, though sometimes in combination with a royalty payment and/or corporate income tax.

There are often concerns that governments' have negotiated bad deals that will see the bulk of project profits go to foreign companies. In some cases these bad deals appear to be the result of corruption, but in many cases they are likely the result of the profound asymmetry of expertise between multinational companies and relatively inexperienced government officials. It is also common for governments to offer investment incentives or tax holidays in order to encourage companies to explore and produce. Exemptions are routinely provided for import and export taxes, customs duties and VAT. In some cases corporate income taxes are reduced or even eliminated.

Once the basic tax rate is established, it is difficult to change. Extractive sector contracts normally contain stabilization clauses that provide protection for the investor from changes to the fiscal terms. There are certainly many examples where

governments have decided to renegotiate the tax terms in contracts, but there is strong pressure to respect the sanctity of the original contracts.

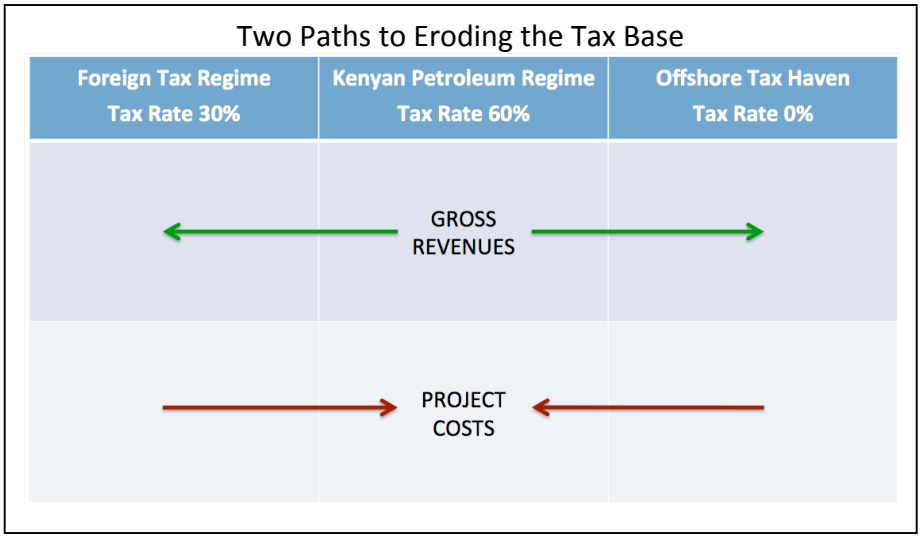
TAX BASE EROSION

The tax rate described above determines what "should" be paid to the government. These headline terms tend to attract the bulk of the attention in comparisons of fiscal regimes. For example, a comparison of fiscal terms commonly compares the rates of profit oil sharing or the rate of corporate income tax. At least as important is the amount of income (i.e. the tax base) that those rates should be assessed against. For example, a 30% corporate income tax rate only becomes meaningful when applied against a company's annual income. Is the tax to be paid 30% of $1 million or 30% of $10 million?

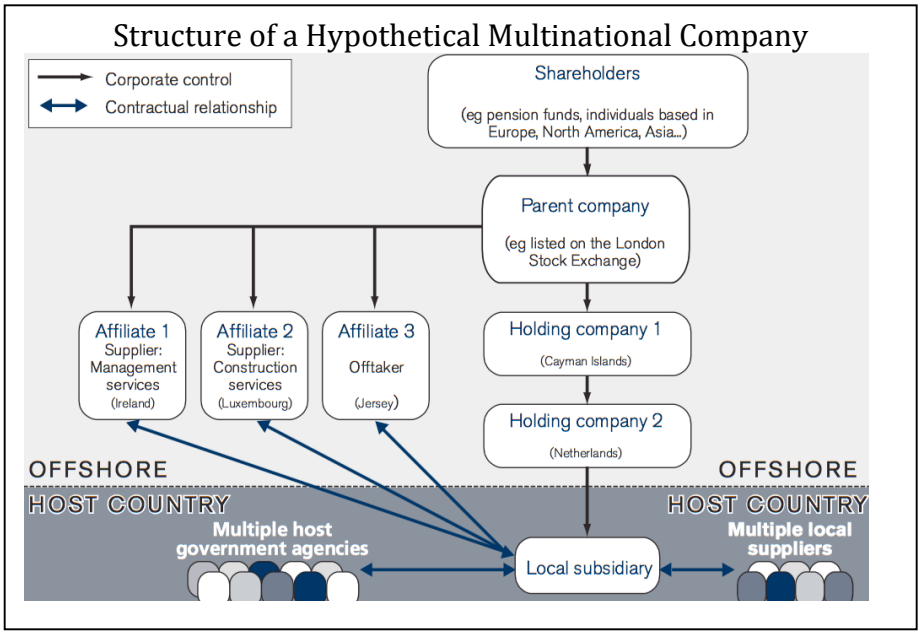
The challenge of protecting the tax base is common to all economic sectors. It is a major focus of revenue authorities. The tax base is even more important in the petroleum sector due to the relatively high effective tax rate. Previous analyses of the existing fiscal regime for petroleum in Kenya suggest that about 60% of the divisible (after cost) revenue would be allocated to the government. This is a much higher tax rate than would normally apply to parent companies incorporated in OECD jurisdictions where tax rates are often around 30% or in tax havens where they may be as low as 0%.

There are two basic paths through which the tax base can be eroded. First, gross revenues can be under-reported. This can be done either through reporting less production than has actually taken place or by reporting a sale price below the fair market value. Less revenue reported in Kenya results in greater company profits. In the mineral sector, production and price risks are both considerable. In the petroleum sector, it is comparatively easy to monitor production volumes. Price therefore represents a far bigger risk to government revenues.

The second main path to tax base erosion is the inflation of project costs. Because the bulk of government revenue normally comes from profit-based taxes – that is taxes that are assessed on net income (after cost income) – inflated costs can significantly reduce the tax base.



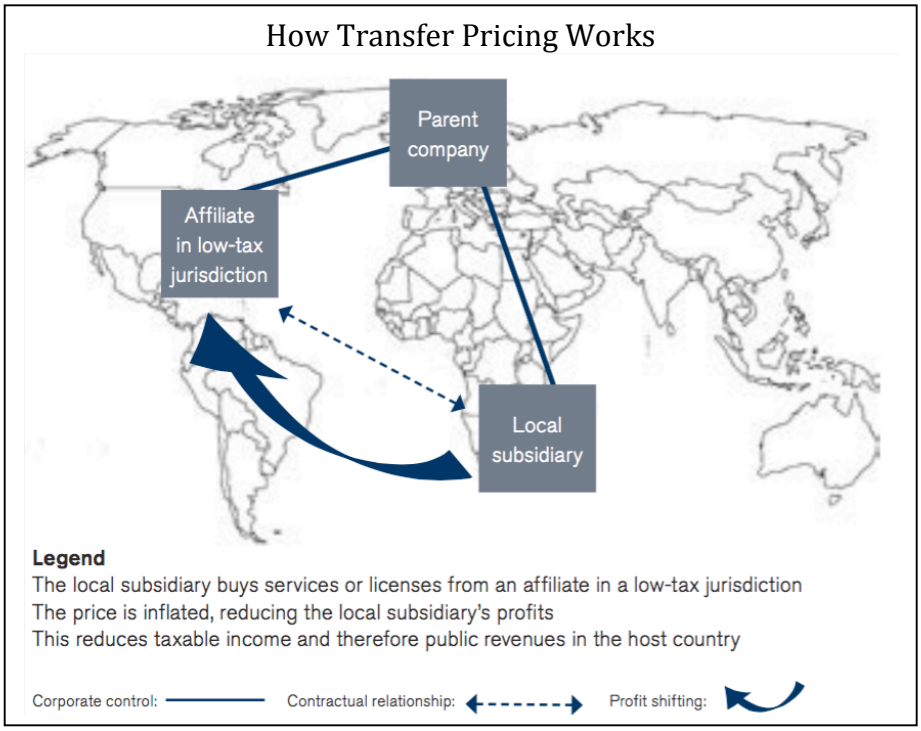
The difference between the tax rates in different jurisdictions create major incentives for companies to minimize the tax base by both shifting profits out of Kenya and shifting costs into Kenya. By doing this they minimize the tax payments that they will be required to make in Kenya while maximizing the profits shift to zero or low tax jurisdictions.



The ability to move revenues and costs between jurisdictions is based on the increasingly complex corporate structures adopted by multi-national corporations.[3] As shown in the figure above, parent companies often use conduit companies – subsidiaries incorporated in tax havens or other low tax jurisdictions – as part of the chain of ownership leading to the petroleum producers in the host country. The parent company may also have affiliates that are involved in purchasing petroleum, providing contractor services, and/or providing management services and financing.

Intra-firm transactions between these subsidiaries create the opportunities for eroding the tax base through profit shifting.

As the main risk to government revenues is mispriced transactions between associated companies, the common solution is to benchmark sale price and project costs against third party (so-called "arms length") transactions. The idea is that transactions between unrelated companies establish what might be called a "fair market" price.

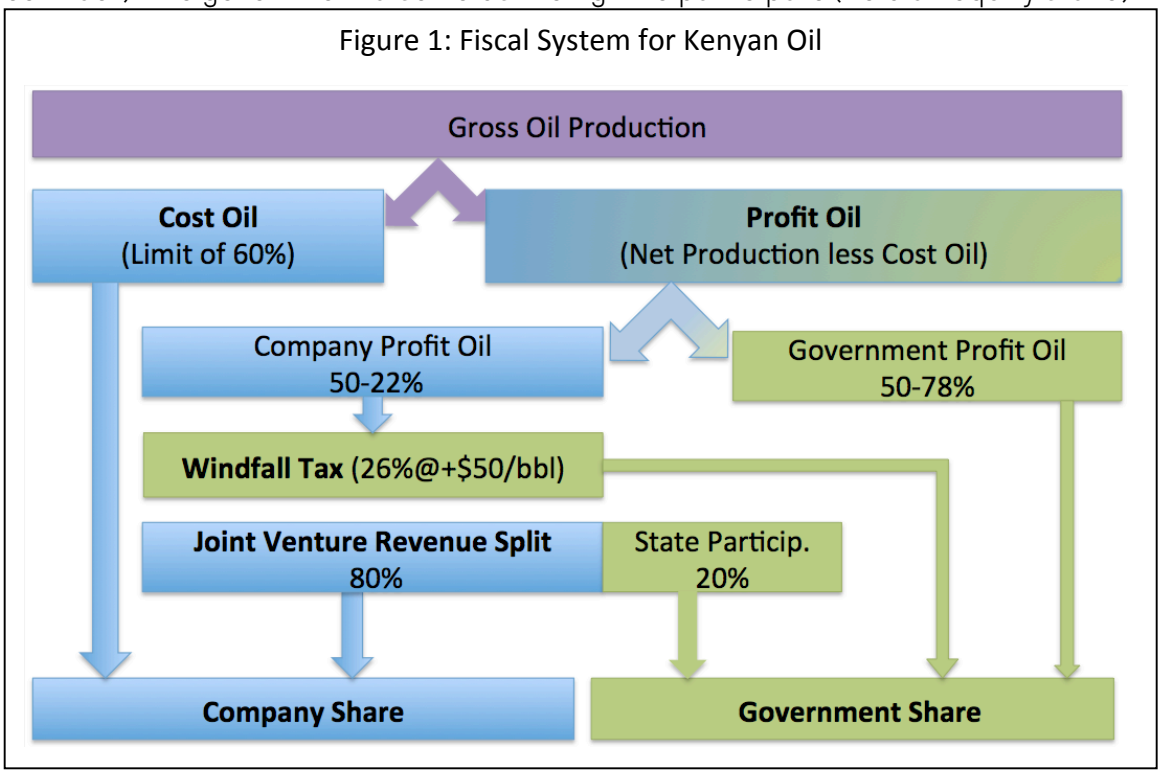


While the solution sounds simple, its practical application is challenging even for well-seasoned tax administrators. First, the definition of associated companies needs to be much broader than just the parent company or subsidiaries within the wider corporate family. A sustained business relationship with any company creates opportunities for transfer mis-pricing. In many cases however these looser associations can be difficult to uncover. Second, assessing the fairness of transactions between associated companies depends on the availability of substantial data on comparable transactions between non-associated companies. Access to an insufficient number of "comparables" is a widespread challenge for developing countries. According to the OECD it is a particular problem where "there are many "first movers" who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables."[4] This is exactly the situation currently facing Kenya's petroleum sector.

SOURCES OF GOVERNMENT OIL REVENUE

Kenya operates a traditional production sharing system. The bulk of government revenue would be expected to come from a share of oil production that is allocated to the government. In addition, the contracts contain a "windfall tax" that is applied on oil when prices exceed a specific threshold ($50-$65 per barrel depending on the contract). The government also holds the right to participate (hold an equity stake)

Figure 1: Fiscal System for Kenyan Oil

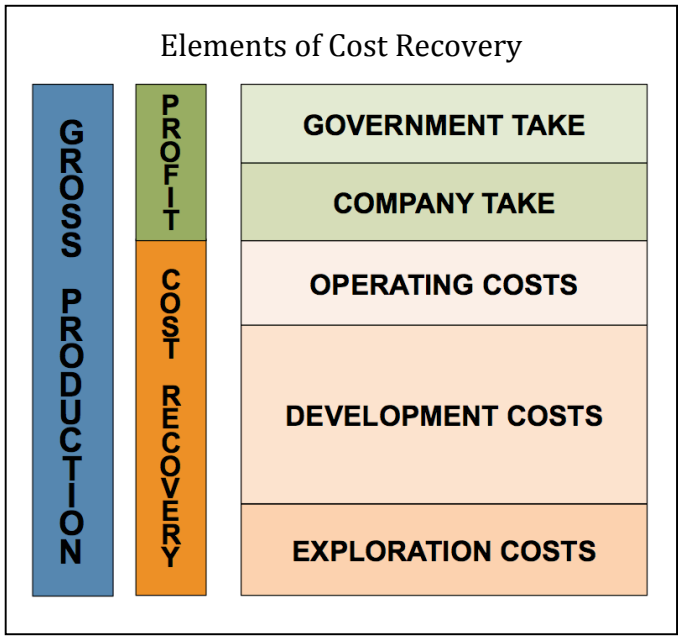


in all oil operations, whether directly or through the National Oil Company of Kenya. **Figure 1** illustrates the sequence in which these three fiscal elements are engaged.

The principal source of government revenue for Turkana oil is the government share of the oil produced. There are two steps in the allocation of oil produced: first, the contractor recovers costs, and second, the remaining oil is divided between the contractor and the government.

COST RECOVERY

Production sharing systems allow the contractor to recover their exploration, production and operating costs through an allocation of an initial amount of production termed "cost oil." As is common in production sharing systems, there is a limit on how fast capital costs can be recovered (20% per annum) and on the overall proportion of production that can be allocated to costs in any given year (60%).[5] These limits have an impact on the timing of government – with greater revenue generated earlier in the project lifecycle – but not on the overall amount of revenue.



SPLITTING PROFIT OIL

Once costs have been recovered, the remaining oil production, known as "profit oil", is split between the company and the government. The Kenyan fiscal system employs a "production-based" allocation. A review of the PSCs in the public domain as well as the fiscal term summaries for other blocks suggests that there is only modest variation in the profit sharing terms. An example from Block 10A is provided in Table 1. For production up to 10,000 barrels of oil per day (bopd), the company receives 50% of profit oil and the government receives 50%. For production exceeding 10,000 bopd up to 40,000 bopd, the split changes to 40% for the company and 60% for the government.

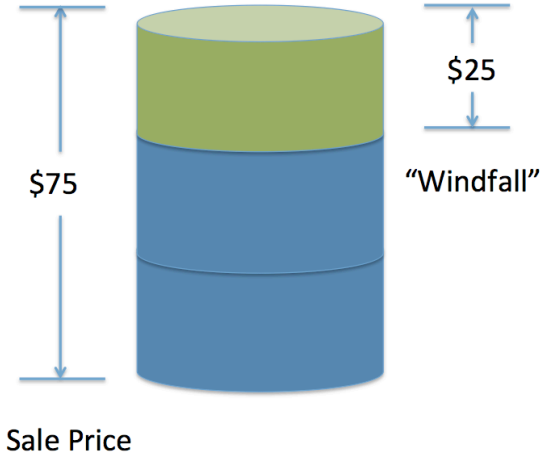
Table 1: Profit Split – Block 10A

Incremental Production Tranches	Government Share	Company Share
1-10,000 barrels per day	50%	50%
Next 30,000 barrels per day	60%	40%
Next 50,000 barrels per day	63%	37%
Next 50,000 barrels per day	68%	32%
Above barrels per day	78%	22%

WINDFALL TAX

Existing Kenyan PSCs contain a "windfall tax."[6] The tax is applied to the company share of profit oil that is generated from oil prices that exceed the "threshold price" at the point of export. In the example shown in Figure 2, an additional tax of 26% would be applied to the $25/bbl of windfall profit with the threshold prices set at $50/bbl. Note that in some PSCs, the threshold rate is set at $65/bbl. In both cases, the price is adjusted for inflation from the signing date of the contract. For a contract signed in 2008, the threshold price of $50/bbl adjusted for inflation would be around $59/bbl. In addition, the discount related to oil quality (perhaps as high as $10/bbl) would also be deducted prior to the assessment of the windfall tax. As a result, the windfall tax has no impact on government revenues unless prices were to be well above $65/bbl.

Figure 2: Windfall Tax at $75/bbl



STATE PARTICIPATION

The Kenyan production sharing contracts all provide for the participation of the state either directly or through the National Oil Corporation of Kenya.[7] The minimum state share is 10%; for some contracts it is as high as 22%. Taking an equity interest in a project means that the State participates on essentially the same terms as other joint venture partners, once the project moves into the development phase. Once production begins, the state would pay its share of costs within the joint venture and secure its share of profit oil.

OTHER POTENTIAL SOURCES OF GOVERNMENT REVENUE

According to the PSCs, no additional taxes are imposed on companies engaged in petroleum production in Kenya. Article 27(5) of the 2008 model PSC clearly states that the government's share of profit oil is inclusive of all income or profit-based taxes including corporate income tax and the dividend withholding tax. This same formulation exists in all Kenyan PSCs in the public domain.
Similarly, Article 32 of the model PSC provides exemptions for taxes, charges, fees, duties or levies of any kind in the export of petroleum as well as for the customs duties and other fees associated with importation.

REVENUE RISK ANALYSIS

Previous analysis of the Kenyan fiscal regime applied to a plausible project in Turkana indicates that the government's share of profit oil constitutes the vast majority of potential government revenue. As discussed above, the windfall tax is a much more modest source of government revenue and is activated only at prices above $65/bbl. And while government revenue through state participation could be significant (perhaps 10% of project divisible revenue), the potential risks to that revenue relate more to the operations of a state owned enterprise than to petroleum economics. The analysis below therefore focuses exclusively on the risks to the government share of profit oil.

RISKS FROM DEPRESSED OIL PRICE

The starting point in protecting the tax base is to ensure accurate reporting of the two components that comprise gross revenue: the total volume of oil produced and the sale value of that oil. Determination of the volume of oil produced does not normally create significant risks to government revenue, as the methodologies for measurement are widely accepted. This is the case even where multiple sources of oil move through the same pipeline. The risk is greater in accurately assessing the true market value of the oil. One specific concern is that oil may be sold to an affiliated company for a price below true market value. In countries where tax administration is weak, this kind of transfer pricing can create opportunities for tax evasion (See Textbox on Alaska and oil price).[8]

The starting point for an analysis of oil price is the valuation provisions in the PSC. Two provisions are particularly important: the point of valuation and the determination of the sale value. The valuation point is normally set at the port of export or the place where the petroleum passes from upstream (exploration and production) to downstream (refinement and sales). According to the definitions in the Kenyan 2008 model contract, the "Sales Value of Crude Oil shall mean the gross sales price at the Delivery Point of export or the agreed delivery point in Kenya or the point of entry into a refinery." Clarity on the valuation point is particularly important as it determines what costs can be recovered within the production sharing system. There may still be some uncertainty on the point of valuation in the case of pipeline transportation.

Alaska Sues Oil Companies for Undervaluing Oil

The American state of Alaska illustrates the risks to government revenue of oil mispricing. Over the first 25 years of oil production, Alaska received approximately $70 billion in revenue from royalty payments and corporate taxes. However, based on independent analyses and audits, Alaskan officials claimed "industry chronically reduced the bases for calculating royalty, severance, and income tax payments by underestimating the market value of a barrel of oil at the point of sale." Specifically, companies sold small volumes of oil at below market prices and used these "low" prices for their overall royalty and tax calculations.

In order to secure a fair share of revenues, Alaska paid lawyers and accountants hundreds of millions to pursue legal claims that ultimately generated an additional $10.6 billion in government revenue. And these figures substantially under-estimate the scale of abuse. Many other claims were launched against companies but were settled out-of-court and the resulting payments are therefore confidential.

The second key question is how the value of the petroleum will be determined. It is common in production sharing agreements to base valuation on sales to non-associated companies. However, as the case study of Alaska demonstrates this solution remains vulnerable to abuse. Some countries are moving towards using international benchmark prices as quoted on commodity exchanges, sometimes taking into account quality differences.

The 2008 model PSC states that oil valuation will be the weighted average of oil sales "to third parties at arm's length during the calendar quarter," adjusted for grade, gravity and quality of such crude oil as well as for transportation costs. If there have been no crude sales to third parties, oil valuation will be the "fair market value" determined as the average price for crude oil produced in Kenya and in the major crude oil producing countries, and adjusted for grade, gravity and quality as well as for transportation costs and any other appropriate adjustments.

The economic benefits to the company from depressing oil price are found in the reallocation of oil production from profit oil to cost oil. Lower prices mean that a

greater proportion of total production must be allocated to costs, resulting in less profit oil to be allocated to the government.

Revenues at Risk: Under-reporting of the oil sale price by just $2 per barrel could result in a loss of government revenue of around $1 billion over the project lifespan.

RISKS FROM INFLATED COSTS

Government revenue from the extractive sector are determined by four main variables: the volume of resources sold, the price at which they are sold, the costs involved in production and the rates of taxation. Of the four, the least attention is normally given to costs. Yet experiences in other resource-rich developing countries suggest that ineligible and inflated costs are a major source of lost government revenue.

As discussed above, the main source of Government revenue in a production sharing system is the share of overall production (profit oil) allocated to the government. Profit oil is divided between company and government only after "cost oil" has been allocated to the company to reimburse eligible project costs. Any increase in project costs will result in a decrease in available profit oil. Where increased expenses are legitimate, both the company and the government suffer. There is simply less "profit oil" to be shared. But where ineligible or inflated expenses are accepted, the company receives the full value in cost oil rather than a portion of the value through profit oil.

In some cases, expenses claimed are simply ineligible. Examples, drawn from actual cases, include companies seeking to claim expenses:

- incurred prior to the signing of the PSC;
- for personal interests of expatriate employees and families;
- for technical training of expatriates;
- involving duplicate invoices for goods or services that have already been expensed;
- ineligible expenses according to the PSC such as oil and gas marketing fees, or expenses related to mergers, acquisitions, or transfers in participating interests.

In other cases, the price of legitimate goods and services are intentionally inflated. This practice, known as transfer mis-pricing or mis-invoicing, is of particular concern for transactions between affiliated companies. For example, offshore drilling is contracted to another subsidiary of the same parent firm. The invoice ultimately submitted for the work is inflated by 10% beyond what the drilling was actually worth. The 10% in this scenario is recorded as a cost to the project, but is in

fact profit for the company. This "profit "is ultimately reported in a low tax jurisdiction – a process known as profit shifting. Contracts normally contain clauses requiring that all transactions between affiliated companies are based on "arms length prices," but these are notoriously difficult to enforce.

COST RECOVERY RISKS

Experiences in other resource-rich countries suggest that companies routinely inflate expenses in order to maximize profits. Timor-Leste, for example, has embarked on a comprehensive audit program that has already yielded hundreds of millions of dollars in additional government revenue (See Textbox).[9]

One might think that tax avoidance through inflating expenses was a problem limited to smaller developing countries with weak administrative capacity. These risks however are inherent in the production-sharing model. In the words of the Indian auditors, "it is inconceivable that the private contractor would fail to protect his financial interests, and assess every investment/ operational proposal to see whether it would result in incremental revenues for him both in terms of cost recovery and contractor's share of profit petroleum." The challenges are so fundamental that Indonesia rewrote their laws to try to minimize abuse[10] while India considered abandoning the production-sharing model entirely. [11]

Timor-Leste Uses Tax Audits and Lawsuits to Defend Government Revenues

Timor-Leste is the most oil dependent economy in the world. At peak oil prices, petroleum revenues accumulated at a rate of more than $250 million per month. The money flowed so fast that for many years that Timor-Leste devoted little effort making sure that they received what they were actually owed. The international accounting firm Ernest and Young acted as the independent auditors from 2007-2010 and, as is common practice, were paid by the companies. It is alleged that the accounting company contested few if any of the company expense claims.

In 2011, Timor Leste initiated a series of tax audits covering the years 2005-2010. The audit process had an immediate short-term impact on revenues with a reported $79 million being recovered in the first round. The longer-term implications could be even more significant with the government reporting that it is continuing to pursue a further 28 assessments against the oil companies that could amount to hundreds of millions, even billions, of dollars in back taxes.

The Timor Ministry of Finance reported that during 2012 alone it had received more than $400 million from "audit-related activities." In that same year, the government launched legal action against ConocoPhillips to recover more than $200 million in unpaid taxes. In February 2016, following arbitration in Singapore, the parties reached a settlement. The outcome however is unknown, as according to the terms of the settlement the amount that ConocoPhillips is to pay will not be disclosed.

There is no simple answer to the obvious questions of whether inappropriate claims are honest mistakes or attempts to avoid taxation. There is often a disconnect between the spending money as part of petroleum production, and the claiming of expenses as part of cost recovery. Developing and operating petroleum projects is the realm of engineers and project managers, while maximizing company revenues by minimizing tax payments is the realm of accountants and lawyers. Consider for example the following advertisement for a "cost recovery auditor" to work for a Canadian oil company in Chad. The first responsibility for this employee is "Managing the *maximization* of cost recovery and reimbursement by identifying variances and specific costs as stated within the companies' Production Sharing Contracts (PSC)."

Proving that mistakes in company expense claims are intentional is difficult. Companies never want to admit to purposeful fraud. Even when companies agree to tax settlements, they seek to avoid any implication that of intentional wrongdoing.[12] Who benefits from inappropriate expense claims however provides some insight into the question of intentionality. It seems almost impossible to find examples in audits of oil company books where errors resulted in an increase rather than a decrease in tax payments to government.

THE IMPACT OF INFLATED COSTS

The economic benefits to the company from inflating costs are determined by the profit sharing split as defined in the PSC. An economic analysis of the potential government revenues from Turkana oil indicates that the Kenyan government can expect to receive about 60% of total profit oil with the other 40% going to the company. The company however receives 100% of the production allocated to cost oil. Thus the inclusion of an inflated or ineligible dollar allocated to cost oil would represent a net loss to the government of $0.60.

Revenues at Risk: Inflating operating costs by 10% could cost the government $300 million over the lifespan of the project.

General and Administrative Costs

General and administrative costs are often a specific point of contention between host governments and international oil companies. Multinational companies commonly incur legitimate costs outside the host country. Support can be in the form of business overheads (e.g., accounting services, human resources management and training, marketing support, procurement), IT services (e.g., software and hardware support, systems acquisition), and proprietary specialized functions and technologies. The costs assigned to the project however should be fair, reasonable, and in line with the market.

Ideally, clear legislation, regulations, and procedures should determine what proportion of indirect costs incurred by an associated company are cost recoverable. In order to limit the potential for abuse, some countries place a cap on the level of headquarters expenses. Mozambique, for example, allows headquarter costs of 5% of overall project costs below $5 million but only 1.5% of overall project costs over $10 million.[13] The Kenyan PSCs also place a cap on headquarter costs, though the provisions seem to vary with some set at a flat 3% of operating costs while others involve a scale similar to that used in Mozambique.[14]

Debt Financing

An area of even greater potential risk is the recoverability of interest costs incurred on money borrowed to finance capital investments. The risk is heightened when an associated overseas company provides the financing. There are two separate dimensions to debt financing.

First, there is the question of the relative proportion of company debt compared to company equity used to fund capital costs. Many tax regimes put a limit on the debt to equity ratio in order to avoid excess debt financing, a phenomenon known as "thin capitalization." Limits are often placed on this ratio so, for example, a country might accept only two parts debt to one part equity (a 2:1 ratio).

Second, there is the question of the interest rate charged on the debt. As with transfer mispricing, affiliated companies often provide the financing. This raises the risks that interest rates are not based on arms-length "market" prices but are rather designed to inflate recoverable cost.

In many countries operating production sharing systems, interest costs are explicitly listed as ineligible for cost recovery. The Kenyan PSCs however are clear that the costs of financing are recoverable. The 2008 Model PSC indicates that "Interest incurred on loans raised by the contractor for capital expenditure in petroleum operations under the contract at rate not exceeding prevailing commercial rates may be recoverable as petroleum costs."[15]

Revenues at Risk: Abusive debt financing (100% debt at 12% interest) could add about $1 billion in costs and reduce government revenues by $600 million over the lifespan of the project.

PROTECTING GOVERNMENT REVENUES

The analysis above indicates that there are major risks to government revenue through the mis-pricing of oil sales and the inflation of project costs. Hundreds of millions of dollars are at stake. What then can be done to protect government revenues?

Clarify Contract Provisions: Clear, simple provisions are widely seen as the best defense against revenue loss. Revising the Petroleum Law and preparing a new model contract will reduce the risk for PSCs signed in the future. Petroleum revenues over the next decade, however, are almost certainly going to be based on already signed PSCs. The terms of these existing PSCs are not easily changed. As is common, the contracts contain a stabilization clause that requires the government to ensure that the relative economic benefits as set out in the original contract remain in place.[16] That said, there will be significant negotiations when companies transition from the exploration to development phase of the project, as is likely to happen in the coming years for Tullow's operations in Turkana. These negotiations provide an opportunity to clarify the interpretation of key provisions in order to minimize the potential for abuse.

Cost Recovery Audits: The most effective government response to the risks of inflated expenses is detailed audits. It is often mistakenly assumed that audits are important once the oil starts to flow. But this is wrong. According to the IMF, "EI revenues are vulnerable to failure to audit during exploration and development phases [...] Neglect in auditing exploration and development expenses can cost the tax base dearly as a project starts to generate income."[17] Emerging African producers including Tanzania[18] and Uganda[19] (see Textbox) are increasingly focusing on auditing exploration expenses in order to protect future government revenue.

Ugandan "Cost Recovery" Audit Program

Commercially viable oil was first discovered in Uganda in 2006. Estimates of recoverable reserves are around 1.2 billion barrels – roughly double the estimated finds in the Turkana region. As with Kenya, full-scale production depends on the construction of a pipeline and exports are unlikely before the early 2020s.

Uganda employs a production sharing system involving a series of separate fiscal instruments including two kinds of royalties, a sliding scale share of profit oil, as well as corporate income and withholding taxes. Already at this early stage the Ugandan government is concerned that inflated exploration expenses could result in the underpayment of revenues to the government.

From 2004-2009, the government relied on external auditors to verify company expenditures through five separate audits. With support from British Aid (DfID), a capacity building program was launched in 2013 to improve the frequency and thoroughness of cost recovery audits. The explicit objective of the program is to disallow inflated claims thereby reducing claims against project revenue and increasing government revenue.

The audits specifically focus on company cost recovery statements and assess whether claimed expenditures are allowable for cost recovery under the terms of the production sharing contracts and are legitimate deductions under the terms of Ugandan corporate taxation law. While the results of the audits are not public, government officials indicate that a significant number of claimed expenses are being disallowed.

In August of 2013, the National Oil Corporation of Kenya invited firms to compete for a contract to audit selected oil and gas exploration companies. The terms of reference call for the audit "to examine and verify all charges and credits relating to the petroleum operations such as books of account, accounting entries, material records and inventories, vouchers, payrolls, invoices and any other documents, correspondence and records necessary to audit and verify the charges and credits." It is unclear, however, whether the work was actually contracted or completed.[20]

Strengthening Tax Administration

Priority must be given to strengthening broader tax administration, particularly as the skills required to administer a PSC are very different to those required for the auditing of normal businesses. Greater capacity will obviously required in the Ministry of Energy and Petroleum and the Kenyan Revenue Agency. Efforts should extend beyond these core organizations, however, to include the Treasury, the Commission on Revenue Allocation, the Office of the Auditor General and officials from relevant county governments. The Kenya Petroleum Technical Assistance Project (KEPTAP), a World Bank supported $50 million technical assistance project designed to strengthen government capacity, includes a focus on the administration of revenue to be generated from the oil sector. This includes specific capacity building in forecasting and collection of oil revenues and taxes as well as "the verification and auditing of recoverable costs proposed by oil companies." But the challenges of stopping transfer pricing should not be under-estimated as the case of Transocean illustrates (See Textbox).[21]

The Challenges of Catching Transfer Pricing

Transocean, the world's largest oil drilling company, provides an interesting example of the challenges of effective tax administration related to transfer mis-pricing in developed countries. On several occasions through the 2000s, the US tax authorities assessed penalties against Transocean amounting to hundreds of millions of dollars. In each case, following extensive litigation, the company managed to avoid payment. Transocean was also at the heart of Norway's largest ever tax fraud case. The government claimed that Transocean dodge as much as $1.8 billion in tax through transfer pricing on the sale of 12 oil rigs between 2000 and 2002. The case lasted for more than a decade before an Oslo court rejected the charges and the Government decided to drop its appeal. The loss is a major blow to the tax fraud office in Norway and may represent a setback for some provisions of Norwegian corporate income tax law.

Encourage Joint Ventures: The asymmetry in expertise between international oil and gas company accountants and lawyers and Kenyan tax administrators, creates obvious challenges. One way to defend Kenyan government revenues from mis-pricing of oil sales or inflated project costs is to encourage joint venture partnerships. The economic interests of partner companies – to reduce costs and increase revenues in order to maximize their share of profit oil – are closely aligned with those of the Kenyan government.

NOTES

[1] See for example: Jack Calder, Administering Fiscal Regimes for the Extractive Industries: A Handbook. International Monetary Fund, 2014; Havard Halland, Martin Lokanc, Arvind Nair, Sridar Padmanabhan Kannan, The Extractive Industries Sector: Essentials for Economists, Public Finance Professionals, and Policy Makers. Washington, DC: World Bank, 2015; and Lorenzo Cotula, Foreign investment, law and sustainable development: A handbook on agriculture and extractive industries, International Institute for Environment and Development, 2016.
[2] See Calder, Administering Fiscal Regimes, p. 70.
[3] For an excellent introduction see: Foreign investment, law and sustainable development: A handbook on agriculture and extractive industries, 2nd Ed. 2016. Illustrations used here are taken from p. 47 and 25.
[4] See Transfer Pricing Comparability Data And Developing Countries, OECD, 2014, p. 2.
[5] For example, a 60% cost recovery limit applies to Blocks 9, 10A, 11A, and 12B.
[6] Article 27(3)(c).
[7] See Article 28.
[8] See Richard A. Fineberg, Securing the Take - Petroleum Litigation in Alaska, in Svetlana Tsalik, *Caspian Oil Windfalls: Who Will Benefit?,* Caspian Revenue Watch, 2003, chapter 3, pp. 53-69.
[9] See Council of Minister's Press Releases: "Timor-Leste Improves Domestic Revenue Collection for 2011," 14 May 2011; "Timor-Leste confirms action underway to reclaim taxes," 10 July 2012; "Making the Oil Companies Pay what they Owe," La'o Hamutuk, 25 June 2013; Timor Government Press Release: "First tax trial delivers positive result," 21 March 2013; and Joint News Release: Timor-Leste and ConocoPhillips Australia settle tax disputes, February 2016.
[10] See Government Regulation No. 79/2010.
[11] See "Performance Audit of Hydrocarbon Production Sharing Contracts," Report No. 19 of 2011-12 for the period ended March 2011, Ministry of Petroleum and Natural Gas and Report of the Committee On the Production Sharing Contract Mechanism in Petroleum Industry, December 2012.
[12] See for example: See: "Unocal to Settle Price-Fixing Suit for $78 Million: The Firms Admit no Wrongdoing in the Proposal, One of the Largest Settlements Reached in a State Antitrust Action Against the Oil Industry," Los Angeles Times, February 7, 1991,
[13] See Mozambique EPCC, 4th Licensing Round, Accounting Procedures Annex C.
[14] Kenyan G&A limits are set out in the Accounting Procedures 2.11. The Anadarko uses sliding scale according the volume of costs (PSC, L-05) while the CAMAC contracts contain a flat 3% limit (PSC, L-16).
[15] See Appendix B – Accounting Procedures, 2.12.2.
[16] See Article 40(3).
[17]Fiscal Regimes for Extractive Industries, IMF, 2012, p. 67.
[18] See Francis Mwakapalila, Tanzania's Experience In Audit Of Extractive Industries, Working Group on Audit of Extractive Industries, August 2014, p. 15 and Collaboration between Tanzania, The Netherlands and Norway on oil and gas related auditing issues, Norwegian Embassy, 2015.
[19] See DFID Business Case: URA Oil Taxation Capacity Building Programme, 2012 and Anthony Kimuli, Enhancing SAIs Capacity to Audit Extractive Industry – The Ugandan Experience, 2015.

[20] See, Expression of Interest for Audit Services for Oil and Gas Exploration Companies in Kenya, NOCK/PRC/03/(760) 2 August 2013.

[21] See Peter Gottschalk, The Role of Lawyers as Defenders of White Collar Criminals, in Corruption, Fraud, Organized Crime, and the Shadow Economy, 2016, p. 77-78.