An Evaluation of Kenya's Profit Petroleum Fiscal Regime under the Petroleum Act 2019 and the Contractual Implication of Migrating from Drop to R-Factor

BY

Castro Kevin Ogutu

Student Number: 131364

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Declaration

I, Castro Kevin Ogutu, declare that this thesis which I submit for the degree of Master of Laws at Strathmore University Law School, is my original work and has not previously been submitted for a degree at another university.

Signed  Date 10/ 11/21

Approval

The thesis of Castro Kevin Ogutu was reviewed and approved by the following:

Dr. Francis Kariuki
Lecturer, Strathmore Law School (Principal Supervisor),
Strathmore University

Thomas Mitro
Lecturer, Strathmore Law School (Co-Supervisor),
Strathmore University

Dr. Peter Kwanjera
Dean, Strathmore Law School,
Strathmore University

Dr. Benard Shibwabo
Director of Graduate Studies
Strathmore University

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Abstract

Countries with developing oil and gas sectors have in the past years centered on the volumes of crude oil produced as a basis of their profit petroleum share with International Oil Companies (IoC). However, there exist other profit petroleum sharing fiscal regimes which focus mainly on profitability arising from the production rather than the volumes produced in light of current global prices and cost recoverable allowed. As a result, Host Governments (HG) are in the process of relooking at their petroleum contracts with IoCs in light of this development.

Kenya has not been left behind either and it has proceeded to change its petroleum laws to reflect this new development, which may trigger the need for renegotiating its Production Sharing Contracts (PSCs) with the International Oil Companies (IOCs) in accordance with the terms of the PSC. The current PSCs are based on a profit petroleum sharing mechanism known as Daily Rate of Production (DROP) where the government and IOC share profit petroleum based on volumes produced. Amongst the changes made in Kenya’s petroleum legal sector is the introduction of the R-factor fiscal regime to replace DROP as a basis of profit petroleum sharing between the IoC and the Government of Kenya.

This research attempts to qualitatively evaluate the two profit petroleum fiscal regimes namely Daily Rate of Production and the R-factor mechanism with a focus on the contractual implication of the migration from DROP to R-factor mechanism. As a yardstick, the research analyzes the legal framework governing Mozambique’s profit petroleum fiscal regime in order to draw key lessons for implementation by Kenya. This study finds that Mozambique had changed its petroleum laws and successfully implemented the R-factor profit petroleum sharing in its concessions with IoC’s which in turn has increased the Government’s profit petroleum share.

This study was conducted through analysis of primary and secondary data such statutes, journals, scholarly books and reports of various international organizations. The study aims at informing the Government of Kenya and other countries on the need to develop and implement sound petroleum sharing fiscal regimes for their countries so that they can maximize on the profitability of the oil and gas sector.

List of Abbreviations/Acronyms

BOPD	Barrels of Oil per Day
EPCC	Exploration and Production Concession Contract
EPRA	Energy and Petroleum Regulatory Authority
DROP	Daily Rate of Production
GoK	Government of Kenya
HG	Host Government
HGI	Host Government Instrument
IoC	International Oil Company
IMF	International Monetary Fund
INP	National Petroleum Institute
KIPPRA	Kenya Institute for Public Policy Research and Analysis
MmBBo	Millions of Barrel of Oil
NoC	National Oil Company
PSC	Production Sharing Contract
RoR	Rate of Return

LIST OF STATUTES

Kenya

1) Constitution of Kenya 2010
2) Energy Act 2006 No.12 of 2006
3) Petroleum Act, 2019 No.2 of 2019
4) Petroleum (Exploration and Production) Act Cap 308.

Mozambique

1) Hydrocarbon Tax Law No.27 of 2014
2) Petroleum Activity Law of 1981
3) Petroleum Law No.21 of 2014
4) Petroleum Tax Law No.27 of 2014

TREATIES/CONVENTIONS

1) International Covenant on Civil and Political Rights 1976.
2) United Nation General Assembly Res 1803 (xvii),Res 3171(xxviii), Res 3281(xxix)
3) Vienna Convention on the Law of Treaties 1969.

LIST OF CASES

1) Amoco Intl. Fin. Corp. v Govt. of Islamic Republic of Iran, 15-Iran- U.S.C.T.R, 189
2) British movietone news Ltd v London District Cinemas (1952) A.C. 166(H.L)
3) Church Mut. Ins. Co v Klein (Colo. App. 1997).940 P.2d 1001
4) Coopers &Lybrand v Bryant 1995(3) SA 761
5) Engelbrecht v Senwes (2007) 35A,29 SCA
6) Everfresh market Virginia (Pty)Ltd v Shoprite Checkers (Pty) Ltd 2012(1) SA 256(CC).

Feldman Carpa v Mexico ICSID Case No. Arb.(AF) 99/1.

7) Gabcikovo-Nogymoros- Hungary v Slovakia, ICJ GL No.92 (1997).
8) Himpura California Energy Ltd v PT.(Persero) Perusahaan listruik Negara (1994).
9) Liberian Eastern Timber Corporation v Republic of Liberia,ICSID Case No. ARB/83/2.
10) Pakerings- Compagneit v Lithuania ICSID Case No. Arb.(05/8).
11) S.Instone & Co Ltd v Speeding Marshall & Co Ltd (1916), 33 T.L.R 202
12) Yury Bogdanov v Republic of Moldova, 114/2009.

DEFINITION OF TERMS

Some of the key terminologies used in this study are;

DROP- A form of profit petroleum fiscal regime that bases profitability on the daily rate of production.

PSC- A commercial contract between the IoC and HG governing the extraction of oil within a HG territory.

R-factor-A form of profit petroleum fiscal regime that derives profit petroleum sharing by dividing cumulative costs by cumulative revenue.

Ring fencing- Costs incurred from one resource area are not used to offset costs incurred from another resource area.

Profit petroleum-Share of oil after taxation that remains and is to be shared between the IoC and the HG

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Chapter One: INTRODUCTION TO THE STUDY

1.1 Introduction

Generally, the discovering, developing, exploiting and closing of an oil and gas field is a capital-intensive venture worth hundreds of millions of dollars and takes decades to accomplish. Moreover, costs that are incurred in the earlier life of an oil field before revenue generation or cash flow are often considered sunk costs[1]to which the bulk of Governments' do not have the adequate resources to venture into or assume such costs.

Further, the unusual rise in international market prices of crude oil between 2002 and 2008, followed by the unforecasted fall on July 2008 reignited conversations on how profit petroleum is shared between owners (Host Government) and companies that extract the resource[2] (International Oil Companies). Conventionally speaking, the Oil and Gas sector (especially upstream-exploration and production) is not an open field and only a few companies have managed to ply this trade hence controlling the sector.

These IoC's[3] have the requisite, technical and commercial capacities to venture into this high-risk business with foreign governments who are well endowed with oil and gas reserves within their territories. [4]These peculiar circumstances often lead HG and IoC's to enter into a legal framework to govern their relationship and utilize the oil resources. The relationship often takes the form of a Host Government Instrument (HGI) and can either be a 'Production Sharing Contracts' (PSCs / PSAs) or 'Modern Concession Contracts (CCs),[5] or a Service Contract' (SCs).

These contracts aim at defining the scope and relation between the HG and IoC from a contractual standpoint of view. The focus of this research however will be on PSC's. PSC's provide that title of the resource remains with the HG while the IoC is contracted to extract and develop the resource in return for a share of production.[6] The HG retains right to reserves in the ground but appoints the IoC in order to develop the resource. The IoC bears risk, cost and expense with regards to exploration, development and production in return

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[1] Nakhle C, *The Taxation of Petroleum and Minerals: The Principles, Problems and Practice*, Routledge,2010, 266.

[2] Nakhle, *The Taxation of Petroleum and Minerals*,204.

[3] Johnston D, 'Changing Fiscal Landscape' *The Journal of World Energy Law & Business* (2008), 31.

[4] Camara A, 'The scramble for investment capital in Africa: How attractive is Guinea's Petroleum fiscal regime?' *Centre for Energy, Petroleum and Mining Law Policy Annual Review* (2016), 55.

[5] Duval C, Le Leuch, H, Pertuzion A, and Weaver, J. L, *International Petroleum Exploration and Exploitation Agreements: Legal, Economics, & Policy Aspects*, (2nd ed), (New York: Barrows Company INC, 2009), pp. 224-225

[6] Davis J, Fedelino A, Ossowski R, *Fiscal Policy Formulation and Implementation in Oil- Producing Countries*, International Monetary Fund,2003, 160.

for a split of production.[7] Apart from the various tax components[8] levied by the HG on the IoC's during the extraction and subsequent production of this resource, they are entitled to a share of the resource. It is this share of the profit petroleum between the HG and IoC that governs the fiscal regime of the Production Sharing Contract.

The share of profit petroleum between the two parties can either take the form of either Daily Rate of Production (DROP) or R-factor fiscal regime.[9] Under the DROP fiscal regime, profit petroleum is allocated based on the average daily rate of production over a specified time with the HG receiving an increased share of hydrocarbon as the average daily rate of production increases through a pre- defined band.[10] On the other hand, the R-factor is a fiscal revenue share that compares cumulative project revenues to cumulative costs inorder to provide the value of R-factor.[11] From this, R-factor determines how the share of profit is allocated between the HG and the IoC.[12]

The Government of Kenya (GoK) proceeded to enact the Petroleum Act in 2019 in order to replace the Petroleum (Exploration and Production) Act of 1986.[13] Under the Petroleum Act 2019, the new Model PSC has incorporated an R-factor fiscal regime which has an implication that all future PSC's in their division of profit petroleum between the GoK and IoC's shall use the R-factor fiscal regime. This provides a prospective shift in the formula for sharing profit petroleum oil.

1.2 Statement of the Problem

HG endowed with commercially viable reserves of crude oil have the capacity to transform their country's due to the revenue stream from exploitation of natural resources through Host Granting Instruments. Kenya has executed several PSCs that govern its oil and gas production under the DROP fiscal regime.

However, with the enactment of the Petroleum Act 2019, that introduces a new profit petroleum sharing mechanism, namely R-factor, there is need to assess the anticipated implication of that shift in compliance with the new law as regards to existing PSC's in light of the existing

[7] Gallun R and Wright C, *Fundamentals of Oil and Gas Accounting,*5th ed, Pennwell, USA,2008.
[8] Moore RC, Moyes CP, and Patterson PD, 'The effect of non-fiscal clauses in Host Government instruments on the fair market value of upstream opportunities,' *The Journal of World Energy Law & Business* (2019), 12.
[9] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts,* 1st ed, Pennwell Pub, Oklahoma,1994.
[10] Beardsworth JJ and Husbands S, *Kenya Oil and Gas Sector Development: Review and Update of the Legal, Regulatory, and Fiscal Framework*,2013.
[11] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[12] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[13] https://www.reuters.com/article/kenya-oil-idUSL8N20Z4D4 on 18 May 2021.

stabilization clause. This is so since attempts to bring back the IoC's to the re-negotiating table to change the terms of the PSC and more specifically to reflect the new profit petroleum fiscal regime (R-factor) becomes futile.

This research draws on evidence from Mozambique's profit petroleum fiscal regime to affirm that the move to the R-factor fiscal regime is in the right direction for Kenya as it will increase its profit oil share in the hydrocarbon. This study provides foresight on how Kenya can borrow a leaf from Mozambique's experience.

1.3 **Rationale/Justification of the Study**

The Oil and Gas sector is a capital-intensive venture requiring a substantial financial and technical investment in order to undertake it. Further, it is a high-risk investment that is unpredictable [14]however if gotten right leads to high returns that benefit the IoC and the Host Government at large. Ideally, the IoC should be able to recoup their investment after production, and so the government should also benefit from the resource as the custodian for its people.

However, this has not always been the case as most HG do not benefit from the oil resource in their possession as some IoC's tend to give such governments the shorter end of the stick.

A poorly negotiated profit petroleum fiscal regime in a HGI by a Host Government is the basis of this shorter end of the stick as the IoC will regain its initial capital investment after the exploration phase and as it moves into full-field development, it will enjoy the benefits of profit petroleum. Worthy to note that these concessions are 20-25 years depending on the geological resource volumes. This time tenure enables the IoC to explore, develop and where appropriate market and sell the resource post-development. In such cases, the IoC stands to enjoy profit petroleum throughout the oil field contracted.

In this regard, a HGI with a well-designed profit petroleum fiscal regime as governed by a Country's statutory enactments can provide more revenue to the HG as well as being more adaptive to change in market circumstances hence more revenue trickling down to its citizens. On the other hand, a poorly designed profit fiscal regime by the HG is a recipe for fleecing the endowed natural resource by an IoC. This is so since statutes are the backbone to which contracts derive their validity and existence.[15] Therefore, a newly enacted statute can invalidate

[14] Land B, 'Capturing a fair share of fiscal benefits in the extractive industry,' *Transnational Corporation* (2010),157.
[15] Hawthorne L, 'The Principle of Equality in the law of Contract,' *THRHR* (1995).

a pre-existing contract between parties since such a contract does not abrogate or override laws enacted from public concern.[16]

1.4 **Significance of the Study**

This research aims at enlightening Kenya and other Countries to negotiate and design better fiscal regimes especially in the context of profit petroleum. In the same line, it will enable Kenya to design fiscal regimes that are robust in nature and cover future circumstances. Further, it will enable Kenya negotiate for a better profit-sharing mechanism as this will increase its revenue stream enabling it to benefit from the natural resource over the life line of the project.

1.5 **Research Objectives**

i. To examine Kenya's legal framework for profit sharing under PSC's.
ii. To assess the legal implication of Kenya changing its profit petroleum fiscal regime from DROP to R-factor to already existing PSC's.
iii. To establish whether Mozambique's R-factor fiscal regime has resulted into increased Government's share of profit petroleum.
iv. To provide recommendations on how GoK can change its current PSC's.

1.6 **Hypothesis**

Requests by a party to a PSC for any changes to the terms of a PSC especially the fiscal systems will need to overcome various legal barriers that must be understood by both all parties to the contract.

1.7 **Research Questions**

I. What are the legal provisions governing profit petroleum fiscal regime in Kenya?
II. Which provisions in existing PSC and petroleum law will impede Government of Kenya's ability to change its fiscal terms.
III. What lessons can Kenya learn from Mozambique on changing its profit petroleum fiscal regime?
IV. What are the key fiscal regimes in profit petroleum share in a HGI?
V. What are the components of these key fiscal regimes?
VI. How can the Government of Kenya change its existing PSC's?

[16] Church Mut. Ins. Co v Klein 940 P.2d 1001 (Colo. App. 1997).

1.8 **Research Methodology**

1.8.1 Introduction

Oil and Gas sector is a nascent industry in Kenya and there is limited scholarly publications on this topic locally. The research is premised on review and analysis of primary and secondary sources of literature. Literature used was taken from development banks, international financial institutions, books, statutes and prominent scholarly articles that have analyzed petroleum fiscal systems and international commercial contracts.

The research is largely anchored on qualitative analysis of information.

This research included: canvassing various relevant literature in order to identify the various factors that would provide the analysis framework; collecting information that would resonate to the variant fiscal regimes available to HG's and the fundamentals to contractual relations as regards commercial contracts; gathering data on about the fiscal regime in the oil sector in Kenya and learning more about current fiscal regimes in use and their impact in HG share of profit petroleum.

The research adopted a comparative study approach with an emphasis on Mozambique. Mozambique being an already oil and gas producing country uses the R-factor fiscal regime in its profit petroleum fiscal regime and due to the similar challenges it faced like Kenya makes it ideal for this study.

The design of fiscal regimes made an assumption that there are institutions of good governance which is essential in maximizing the generation of profit petroleum within the HG. Without these institutions and good governance mechanisms to facilitate administration of these policies, the HG cannot benefit from such. However, the importance of good governance and institutions in oil producing African states is well documented in various literature and will not be revisited in this discourse.

1.9 **Theoretical framework**

PSC's in their basic structure are contracts since they define the obligations and rights of the parties regarding the exploration and production of oil and gas in a defined area and time.[17]

The legal concept of relational contractual theory is partly attributable to Aikaterini Flourou a British legal scholar.[18]According to her, relational contracts are characterized by extreme

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[17] https://www.lexisnexis.co.uk/legal/guidance/production-sharing-contracts accessed on 3rd October 2021.

[18] Flourou A , *Contractual Renegotiations and International Investment Arbitration: A Relational Contract Theory Interpretation of Investment Treaties*, Brill Nijhoff,Leiden,2020.

uncertainty, long term durations and transactional investment dependent for their profitability and success on the contracting parties.[19] Flourou's view is to be adopted as it is particularly relevant for this study as she underlines that public concessions which involve partnership bears characteristics of relational contracts especially sunk investment and changing circumstances as the project evolves.[20] This is the same position with PSC's which tend to have high upfront sunk costs in the exploration stage of the hydrocarbon development.[21] Additionally, the ever uncertain geology of the hydrocarbons provide the ever changing circumstances.[22]

Accordingly, PSC are long term contracts that span over twenty years with already sunk cost to it. Secondly, the ever-changing geology or global market prices of crude oil provides a huge uncertainty as regards the life of PSC. Flourou submits that such public concessions are frequently renegotiated at the request of foreign investors with the relationship between the contracting parties particularly motive being considered during re-negotiations.[23]

Consequently, she posits that relational contract theory ought to apply similarly to the State in that a State can request to re-negotiate its long term concession contract with a foreign investor while looking at the motive. [24]This is relevant to the study in that a HG can request to re-negotiate the terms of its PSC with an IoC and while at it, the motive being mutual economic benefit be the basis.

1.10 **Literature Review**

The reflection and collection of the literature review to this research attempts to review various studies that have been undertaken in regard to the profit petroleum fiscal regimes and contractual relationships as regards to contracts. The literature is reviewed thematically. The following themes are discussed: choice of petroleum fiscal regime; …….*pact sunt servanda* and change of petroleum fiscal regimes.

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[19] Flourou A , *Contractual Renegotiations and International Investment Arbitration: A Relational Contract Theory Interpretation of Investment Treaties*, 57.
[20] Flourou A , *Contractual Renegotiations and International Investment Arbitration: A Relational Contract Theory Interpretation of Investment Treaties*, 72.
[21] Nakhle, *The Taxation of Petroleum and Minerals*.
[22] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.
[23] Flourou A , *Contractual Renegotiations and International Investment Arbitration: A Relational Contract Theory Interpretation of Investment Treaties*, 85.
[24] Flourou A , *Contractual Renegotiations and International Investment Arbitration: A Relational Contract Theory Interpretation of Investment Treaties*, 106.

(a) Choice of petroleum fiscal regime

According to Tordo S, in the extractive industry, a HG seeks economic rent on the natural resource through the enactment of legislations that govern natural resources which in turn lays the foundation for the legal and financial criteria of granting of exploration and production rights for the natural resources either through concessions or contracts.[25]

A study by Johnston D[26] has shown that the key objective in choosing the type of any petroleum fiscal regime is first and foremost to enable the HG's get equitable share of proceeds arising from the exploitation of the natural resource while also allowing the investor to economically recover his investment from the natural resource.

The legal and fiscal system chosen by a country is essential as it talk to the rights and duties of the HG and IoC including division of profit petroleum which is a vital component between the two parties. In addition to this, Nakhale C[27] argues that where a party fails to negotiate proper and sound fiscal terms that speak to their economics, in the long run, it becomes difficult to recall the other party back to the table to renegotiate other terms or change the terms of the previous agreement.

Maniruzzman F,[28] has stressed that, in the event that a HG intends on changing its fiscal regime, it must consider its contractual and legal implications and in doing so, the key issue to be analyzed will be that of stabilization clause. Maniruzzman F, further posits that stabilization is a key clause in investment contracts and is divided into two main broad categories namely freezing clause and economic equilibrium clause.[29]

Maniruzzman F states that, the freezing clause is generally designed to stop the HG from introducing contractual alterations that would adversely affect the investor. In essence, freezing clause 'freezes' any changes that are brought about by legislation or any changes to a contractual relationship. The economic equilibrium/renegotiation clause does not stop the change in law or contractual obligations but aims at restoring the IoC back to the same financial

[25] Tordo S, 'Fiscal Systems for Hydrocarbons- Design Issues,' *World Bank Working Paper No 123,* (2007).
[26] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.

[27] Nakhle, *The Taxation of Petroleum and Minerals*.
[28] Maniruzzman A.F.M, 'Damages for breach of stabilization clauses in international law investment law: ' Where do we stand today?,' *International Energy Law and Taxation Review*,(2007).
[29] Maniruzzman, 'Damages for breach of stabilization clauses in international law investment law: Where do we stand today?*'* 247.

position it was prior to the changes in legislation.[30] Stabilization is widely considered in investment contracts. However, the same should be considered in light of the shifts in international economic relations.

According to Johnston D, profit petroleum is considered oil that remains after the cost oil, royalty and the various taxes including income tax has been deducted.[31] He proceeds to note that profit petroleum is shared between the HG and IoC in what is termed as “contractor/ government take” respectively.[32] Johnston D argues that this contractor/government take often provides a comparison between one fiscal system and another with the focus mainly being on the division of profits correlating directly to factors such as field reserve, size of development and other economic measures.[33]

In the same vein, Daniel, Puyo and Leuch[34] identify R-factor as a revenue sharing formula that is incorporated in a PSC and seeks to divide profit petroleum between the IoC and HG as regards to cumulative cash inflow of the project divided by cumulative cash outflow of the project.

This is further buttressed by the Petroleum Act of Kenya[35] which formulates it as follows:

$R = X \div Y$ refers to cumulative cash inflows are divided by cumulative cash outflow.[36]

Whereby:

X denotes Contractor’s cumulative cash inflows at the end of the preceding calendar Quarter

and

Y denotes Contractor’s cumulative cash outflows at the end of the preceding calendar Quarter

$R= X \div Y=$ cumulative cash inflows $\div$ cumulative cash outflows.

Cumulative cash inflow refers to (cost petroleum + profit petroleum – production costs- decommissioning costs.

Cumulative cash outflow refers to (Exploration costs + Development costs).

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[30] Antoine M, ‘Stability in Contemporary Investment Law: Reconsidering the Role and Shape of Contractual Commitments in Light of Recent Trends,’*Manchester Journal of International Economic Law,* 2013, 2.

[31] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.

[32] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.

[33] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.

[34] Daniel P,Puyo DM,Leuch H, *Technical notes on Extractive Industries Fiscal Regimes*, International Monetary Fund, 2013.

[35] Petroleum Act(No.2 of 2019)

[36] Section 37, *Petroleum Act* (No.2 of 2019)

According to Beardsworth and Husbands[37], in the calculation of R -factor, they provide that once a ratio of 1 is reached, all exploration, development and cumulative operating costs to the date of sharing has been recovered. An R-factor of less than 1 would imply that costs have exceeded revenue hence a loss. There is a direct co-relation of the profitability and the value of R-factor, the larger the R-factor, the more profitable the operation.[38]

Calculating an R- factor is done in each production accounting year where once a threshold is reached, a new sharing ratio is applied in the subsequent accounting year/period. This ideal links both parties in the PSC to profitability. Nakhale further notes that, in exceptional circumstances, the R-factor may fall below zero or is negative leading to government's fall in share. This normally points out to a period of negative cash from the project resulting into cessation of production.[39]

Daniel *et al* under the auspice of the International Monetary Fund (IMF) had proposed changes to Kenya's petroleum fiscal terms in the existing PSC's. They argued that Kenya should modernize its profit petroleum scheme based on an economic criterion that takes into account all economic factors such as price, cost, volume, location and quality.[40]

Similarly, KIPPRA had opined that if the GoK was to adopt the R-factor under the Model PSC, it would have generated more petroleum revenue and it was economically more efficient than the combination of the DROP profit split combined with the windfall tax.[41]

According to Beardsworth *et al.* R-factor is considered to have an array of benefits both to the IoC and HG since it progressively captures windfall situations and does not need additional fiscal instruments such as royalty to maximize on profitability.[42]

As regard DROP, Nakhle states that it is a form of profit petroleum share based on the daily rate of hydrocarbon produced during a specific period (often yearly) with the HG being entitled to a higher progressive share as the average daily rate of production increases through pre-determined bandwidth.[43] Essentially, the sharing framework is pegged on the level of production. The higher the level of production, the higher the sharing ratio between

[37] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[38] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[39]Nakhle, *The Taxation of Petroleum and Minerals*.
[40] Daniel P,Puyo DM,Leuch H, *Technical notes on Extractive Industries Fiscal Regimes*,8.
[41] Kenya Institute of Public Policy Research and Analysis, *A Comparative Study of Oil Producing Countries and Petroleum Revenue Sharing Models: lessons for Kenya*,2018.
[42] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[43] Nakhle, *The Taxation of Petroleum and Minerals*.

the contractor and government. The governments' share of profit hydrocarbon increases as the daily rate of production from a contract area increases.[44]

According to the repealed Petroleum (Exploration and Production) Act, the division of profits is centered on a daily production-based sliding scale system which assumes the first tranche at 20,000 barrels of oil per day (BOPD) whilst the last tranche being 100,000 BOPD. The profit splits are negotiable at each tranche as shown below;[45]

Increments of Profit petroleum	***Government share***	***Contractors share***
First 20,000 BOPD	%	%
Next 30,000 BOPD	%	%
Next 50.000 BOPD	%	%
Over 100,000 BOPD	%	%

Beardsworth notes that the governments' share of production is fixed and does not heed to current changes or developments in the prevailing market.[46] This is a rigid, 'safe' & uneconomical method of sharing production since the Governments' share is fixed in the tranches and has windfall profit to factor in due to higher than expected production levels. Windfall profit refers to profits or gains that are not often forecasted and are sudden in nature as a result of unexpected event or circumstance. Such circumstances range from a sudden spike in market prices or a shortage in supply leading to a bulge in demand for the product.

(b) *Pact sunt servanda,* stabilization clause in *PSC* and the contractual change of petroleum fiscal regimes

As regards the contractual doctrine of *pact sunt servanda*, Hawthorne notes it is an international law principle that is buttressed under the sanctity of contract that obligations in a contract must be honored as the contract was voluntary.[47] In the same vein, Wehberg, notes that *pact sunt servanda* obligates parties to honor the terms of a contract due to the free will of expression in

[44] Nakhle, *The Taxation of Petroleum and Minerals*.
[45] Petroleum (Exploration and Production) Act, Cap 308.
[46] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[47] Hawthorne L, 'The Principle of Equality in the law of Contract,' *THRHR* (1995),58.

the engagement of the contract.[48] In *Everfresh market Virginia(Pty)Ltd v Shoprite Checkers(Pty) Ltd*[49] the court described *pact sunt servanda* as "…the age-old contractual doctrine that agreements solemnly made should be honored and enforced."

In addition to this, the principle is buttressed under international law instruments where it provides that contracts validly entered into by parties are binding and can only be modified or terminated in accordance with the terms or through mutual agreement.[50]According to Rees, the sanctity of contracts hereinafter contextualized in the form of PSCs, provides that morally, the basis of the contract is that the promisor has by his promise created a reasonable expectation the contract will be kept.[51] On his part, Holland notes that when the law enforces contracts "*…it does so to prevent disappointment of well-founded expectations, which, though they usually arise from expressions truly representing intention, yet may occasionally arise otherwise*''.[52]

Sanctity of contracts provides that a HG will not endeavor to alter the fundamental terms of the HGI without taking into consideration the other party's' interests in the contract. The HG is morally & contractual obligated to abide to the rules of the existing contract and not to attempt to change the terms midway. The same principles of rights and justice that prevail between individuals in a contract are the same that controls the HGI between HG and IoC's.

There ought not to be a different construed intention or construction from an ordinary private contract.[53] Further, Dunn FS has written that, "*Private individuals making contracts with foreign governments do not ordinarily foresee that the government will in the future resort to its governmental power to defeat its obligations under the contract. If they did, they would make no such contracts at all, since the scope of governmental power is such as to be able to defeat any normal basis of expectation of the outcome of the contractual relationship.*"[54]

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[48] Wehberg H, 'Pact Sunt Servanda,' 53 *American Journal of International Law*, (1959),775.
[49] Everfresh Market Virginia (Pty) Ltd v Shoprite Checkers (Pty) Ltd 2012(1) SA 256(CC).
[50] Vienna Convention on the on the Law of Treaties, 1969. Article 26 provides for provides for the doctrine of Pact Sunt Servanda that parties ought to comply with. The good faith element of the principle suggests that states to take necessary steps to comply with objects & purpose of the treaty. Invoking restrictions imposed by domestic laws as part of reasons to not perform obligation to contracts is considered impractical.
[51] WJ Rees, 'English Law and the Moral Law. By A. L. Goodhart.' *Cambridge University Press*,(2009).
[52] Holland TE, *The elements of jurisprudence*,12th ed, Oxford clarendon press,1916, 262.
[53] Wadmond LC, 'The Sanctity of Contract between a Sovereign and a Foreign National,' American Bar Association,1957 Addresses Delivered at the London Meeting' (1957) 1957 American Bar Association. Section of Mineral and Natural Resources Law Proceedings available at https://heinonline.org/HOL/P?h=hein.journals/pabminn18&i=189 accessed 11 February 2020
[54] Dunn FS, *Protection of Nationals*, Periodicals Service Company,1974.

The contractual obligations as entered between parties who have free will has significantly changed due to the emerging free market values of the late nineteenth century that aim to create economic mobility and freedom to negotiate a beneficial bargain.[55]In addition to this, Christie notes that, where changes in circumstances occur as between the parties and during the execution of the contractual obligations, the strict enforceability of contractual terms may become difficult same as the strict application of the principle of *pact sunt servanda*.[56]

On the other hand, according to Emeka, stabilization clauses can be traced as early as 1920s when it was used to reduce political risks and preserve contracts between a HG and IoC.[57] The basis for the incorporation of such clauses arose due to the fear of expropriation and nationalization of assets by HG.[58]Siloko argues that, a key function of long-term investment contracts is to facilitate trade and to safeguard investments of the parties so that they can be able to undertake their respective obligations under the contracts in order to achieve the economic gains intended.[59]

Alexander describes stabilization "*the contract language which freezes the provisions of a national system of law chosen as the law of the contract as to the date of the contract in order to prevent the application to the contract of any future alterations of this system.''*[60] Bernadini argues that stabilization often seeks to limit a HG's power to modify the contractual obligations agreed upon either through legislation or administrative powers to an IoC's disadvantage.[61]

According to Gehne, stabilization has metamorphosized over the years and could take either the form of freezing clause, economic equilibrium or a hybrid clause.[62]In Kenya's pursuit to change its petroleum sectoral laws, it has adopted an economic equilibrium clause of the stabilization clause which provides that ''If *after the effective date of this contract the economic benefits of a party are substantially affected by the promulgation of new laws*

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[55] Calvert H, 'Review of Law in a Changing Society,' 2 University of Malaya Law Review (1960), 355. Available at https://www.jstor.org/stable/2487453.
[56] R H Christie, *The law of contract in South Africa*,'5 ed, Butterworth publishers (Pty), 2007,21.
[57] Emeka J,'Anchoring Stabilization Clauses in International Petroleum Contracts' *The International Lawyer* (2008), 1317.
[58] Siloko P, 'Contractual stabilization in international petroleum agreements: what is its validity and function?'
[59] Siloko P, 'Contractual stabilization in international petroleum agreements: what is its validity and function*?'*
[60] Alexander F.A, 'The three pillars of security of investment under PSCs and other Host Government Contracts,' *Fifty-fourth Annual Institute on Oil and Gas Law, (2003).*
[61] Bernadini P, 'Stabilization and Adaptation in Oil and Gas Investments,' *1 Journal of World Energy Law & Business* (2008),100.
[62] Gehne K and Brillo R, 'Stabilization Clauses in International Investment Law: Beyond Balancing and Fair and Equitable Treatment,' *Institute of Economic Law* (2017),7.

and regulations, or of any amendments to the applicable laws and regulations of Kenya, the parties shall agree to make the necessary adjustments to the relevant provisions of this contract, observing the principle of the mutual economic benefits of the parties.'[63]

From the foregoing, there is a clear gap in the existing literature. This is the absence of analysis of literature dealing with migration from DROP to R-factor as regards the profit petroleum fiscal regime. Secondly, there is insufficient literature that addresses the contractual implication of the change from DROP to R-factor fiscal regime in the petroleum sector in Kenya.

1.11 **Assumptions**

The assumptions made herein is that the legislations on which the research is centered on will not be repealed or substantially amended during the course of the study. A further assumption herein is that parties to a contract shall strive to be bound by terms of the contract and each party shall perform its obligation under a contract. However, any significant change in circumstances to a contract makes it difficult for parties to a contract to abide to the terms without seeking for its modification.

1.12 **Limitations**

The research is limited to the documents that are in the public domain since some of the signed PSC's are not in the public domain.

Secondly, the fiscal regimes of different Countries may not be similar and various components of the legal regime may differ accordingly.

1.13 **Chapter Breakdown**

Chapter One: Introduction to the Study

The aim of this research is expounded within five separate chapters. This chapter is introductory in nature. It provides a background introduction to hydrocarbon investments requiring capital intensive investments. Further it addresses the statement of the problem, the research question, justification, methodology, hypothesis, literature review, assumptions and limitations.

[63] Clause 52(3), Model Production Sharing Contract Kenya.

Chapter Two: The Profit petroleum Fiscal Regime in Petroleum Industry

The chapter intends to understand the two key profit petroleum fiscal regimes namely DROP and R-factor. In addition to this, the chapter looks at some of the key principles that underpin petroleum fiscal regimes. The first part of this chapter looks at cost recovery and the relevant capping that is pegged to it. It proceeds to discuss the principle of profit petroleum in light of the government/ contractor take and what form the profit petroleum takes. The other principle to be discussed is the issue of ring fencing, its sub-division, its purpose and how it impacts the cost recovery available to an IoC.

The principle of DROP as a means of sharing profit petroleum shall be discussed while providing an illustration of the same. In discussing the principle of R-factor, an analysis of the same together with its components shall be discussed. In addition to this, an illustration of R-factor shall be provided.

In concluding this chapter, stabilization of PSC's will be discussed. Stabilization clause shall be discussed in detailed as we look into its basis in international investment agreements and as to why parties while contracting, make an emphasis to the clause. In discussing this, it shall look at the various form stabilization clauses take and the resultant effect of the same when applied to a contractual relationship. Stabilization is broadly divided into freezing clause and economic equilibrium clause as will be enumerated below.

Chapter Three: Comparative study of Kenya's and Mozambique's Profit petroleum Fiscal Regime

This chapter seeks to make a comparison of Kenya's and Mozambique's profit petroleum fiscal regime. The first part of the chapter will look into detail at Kenya's regulatory framework governing the profit petroleum fiscal regime. The second part of this chapter will evaluate Mozambique's legal and contractual framework that governs its profit petroleum while making a comparison to that of Kenya. In the process, the necessary similarities and gaps will be identified accordingly and how the Country has implemented its R-fiscal factor in the concession contracts.

Chapter Four: Analysis of Drop & R-Factor Fiscal Regime and the Resulting Contractual Implication on The Change.

The first part of this chapter will discuss in-depth the DROP and R-factor fiscal regimes. It will discuss DROP and the resultant gaps it has that makes it not the best suited fiscal regime for the government to attaining its ideal profit petroleum. The second part will look at R-factor and how it has attempted to seal the gaps in the DROP fiscal regime. An analysis of the two fiscal system shall be done and the same shall be discussed.

In order for a HG to change its fiscal regime, it must consider its contractual and legal barriers and in doing so, the key issue to be analyzed will be that of *pact sunt servanda*, stabilization clause of contracts and contractual interpretation. *Pact sunt servanda* provides for the sanctity of contract as between parties and in the research, it shall be looking at how local courts and international law has addressed the issue of sanctity of contracts. As regards the stabilization clause, the research will identify the type of stabilization clause incorporated in the PSCs and proceed to further offer an interpretation of the same based on the golden rule of interpretation.

Chapter five: Findings, Recommendations and Conclusion

Chapter 5 will provide for the findings, recommendation and conclusion. In doing so, the chapter will provide for the findings on the DROP and R-factor fiscal regime emanating from the research. The chapter proceeds to provide the necessary recommendations and in providing the conclusion, it offers a brief overview of the divergent interest between the IoC and the HG in light of the changes discussed above. Generally, the IoC's aim at maximizing its profitability and finding stability in its investment while the HG aims at protecting its natural resource and finding an equitable share of it.

The chapter proceeds to highlight that PSCs are not cast on stones and there are circumstances that arise that were not considered or factored during the contracting stages and the same are critical and should be heeded to without compromising on the economic interest of the parties. The chapter argues that a change in the fiscal regime is possible and proceeds to state this is possible through parties opening up the stabilization clause and renegotiating the PSC. Renegotiation as well as observing the principle of mutual economic benefit to the parties provides an amiable way of contracting and relooking at the relationship between the parties. The chapter further highlights the challenges to the renegotiation and looks at the other key facets to a change in fiscal regime. It concludes by providing that the adoption of R-factor fiscal regime will indeed yield a more economic efficient return and that a change in Kenya's fiscal regime is indeed justified.

Chapter Two: THE PROFIT PETROLEUM FISCAL REGIMES IN PETROLEUM SECTOR

2.1 **Introduction**

This chapter looks at the fundamental principles that underpin the profit petroleum fiscal regime and the contractual element of PSC's where changes are to be undertaken by either party. Generally, the principles discussed herein below are usually incorporated in a PSC and underpin both DROP and R-factor profit petroleum fiscal regime. As noted in Chapter 1, a PSC defines the relationship between a HG and the IoC as regards the distribution of crude oil between them. Under a PSC, the IoC will bear all the contractual risk for exploration and production purposes while the title to the crude oil is retained by the HG. Under this framework, the IoC is entitled to a share of the crude oil for purposes of recovering their costs and also subsequently a share of the profit petroleum.

The first part will discuss in depth cost recovery which is a key component of both fiscal regimes. It will highlight the necessary costs to be recovered and their order of recovery under a PSC. Further under cost recovery, it shall address the issue of cost capping and why it is necessary to cap costs under a PSC. Secondly, profit petroleum will be discussed while highlighting how the crude oil is shared between the IoC and the HG. It will further highlight how the shared crude oil normally termed as 'the contractor/government take' as described in PSC and the form of receipt of the share being either in kind or cash.

The other principle to be discussed is that of ring fencing of costs under a PSC and more specifically highlight why oil produced from one development area are not to be used to offset costs incurred in the exploration and production of oil from a different development area under the contract area of the PSC.

The chapter further discusses DROP and R-factor while providing examples of their application and also highlighting key features. The chapter shall conclude by looking at the elusive term of stabilization of PSC's and the various models it adopts.

2.2 **Cost Recovery**

Cost recovery is a key term used in PSC to indicate the various costs that an IoC is able to recover from a given hydrocarbon investment. It is worth noting that under a conventional PSC, it is the IoC who injects their money into a project for purposes of realizing the fruition of a hydrocarbon investment. The money invested in the form of capital and as a business principle it needs to be recovered by an IoC in cases where the business bears fruit.[64]

A PSC provides for a mechanism in which such costs incurred in the project life will be recovered by the IoC.[65]Cost recovery share is obtained out of the share of production of the crude and no two Countries have an identical structure on it hence it varies from country to country.[66] Further, depending on where the venture is situated, it can further vary depending on whether its onshore, shallow waters or deep offshore.[67]A PSC provides for cost oil[68] that is used to offset the costs incurred by the IoC to bring the crude to the wellhead or at the delivery point .The cost oil is used for cost recovery purposes by the IoC. The costs that can be recovered by an IoC are wholly classified into exploration, production & development costs. These costs are generally known as 'allowable recoverable costs'.[69]

Exploration costs cover activities such seismic tests, drilling of wells, appraisals while production & development costs include costs such as setting up the infrastructure i.e crude oil pipelines for evacuation purposes, setting up of processing facilities among others. In essence, such costs recovery, enables the IoC to recover its capital and operating expenditure in the investment.[70] The costs are normally classified in occurrence order and most PSC's will provide for a recovery order of such costs. These development costs are usually spread along the life of the investment and are not recoverable at once. A capping to such cost recovery is essential because most HG want revenues from the onset of production and also to delay IoC's from recouping all its capital and operational expenditure in a short span of the project.[71]

Capping of costs that are recoverable enables the HG attain benefits of a hydrocarbon investment during its lifetime[72] while the IoC still achieves its return on investment. Cost recovery cap governs the rate and amount to which an IoC recovers its costs upon the production of a hydrocarbon. Depending on the rate of cost recovery, an IoC can forecast the time frame upon which costs incurred can be recovered prior to the investment being deemed

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[64] Duval C *et al International Petroleum Exploration and Exploitation Agreements,70.*
[65] United Nations , *Handbook on selected issues for Taxation of the extractive industries by Developing Countries,*United Nations,2017,362.
[66] Duval C *et al International Petroleum Exploration and Exploitation Agreements,76.*
[67] Duval C *et al International Petroleum Exploration and Exploitation Agreements,76.*
[68] United Nations, *Handbook on selected issues for Taxation of extractive industries by Developing Countries*,361.
[69] Duval C *et al International Petroleum Exploration and Exploitation Agreements.*
[70] Duval C *et al International Petroleum Exploration and Exploitation Agreements,77.*
[71] Duval C *et al International Petroleum Exploration and Exploitation Agreements*,308.
[72] United Nations, *Handbook on selected issues for Taxation of extractive industries by Developing Countries*,362.

as profitable. The higher the rate of cost recovery, the faster the costs incurred will be recovered in a short life span of the hydrocarbon development and vice versa.[73]

Typically, hydrocarbon costs that are due to an IoC as a result of capital and operational expenditures are capped at a percentage that is normally indicated in the PSC and varies from country to country.[74]

From the cost hydrocarbon, the IoC recovers costs that are equally pooled as exploration, well appraisals, field development, operational, production and abandonment.[75] Such costs are normally recovered in a specified order with costs incurred in the first order pool being recovered before any other costs recovered.[76] Cost recovery varies in different PSC's subject to negotiations as between the parties. The hydrocarbon that are not utilized for purposes of cost recovery are subsequently used for profit petroleum. Where costs are not recovered within a certain year (being the quarter of production), then the IoC is allowed to carry forward such unrecovered costs into the subsequent production year or quarter as determined by the PSC.[77]

A prudent order for cost recovery is based on the occurrence of time in which the costs were incurred. This essentially limits the adverse effect on discounting on the recovery. A case in point is where exploration and appraisal costs must be incurred first to which if they are recovered first, the difference between the present value of the initial expenditure and that of cost hydrocarbon received is reduced.[78]

Cost recovery applies to both DROP and R-factor fiscal regimes. However, the impact of cost recovery under the two fiscal regimes is more tangent in the profit split in that depending on the type of costs recovery allowable, therefore under the DROP regime it will have an impact on the profit petroleum barrels within the respective tranches. Similarly, for the R-factor, the costs recovery allowable under the PSC have a direct impact on the value of the denominator of R-factor thereby either increasing or decreasing its value.[79]

[73] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.
[74] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.
[75] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.
[76] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.
[77] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*,2013.
[78] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*,2013.
[79] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*,2013.

2.3 **Profit petroleum**

It's a key feature in PSCs where HG and IoC's share the crude oil produced in a manner that differs from their contribution of costs towards the development. In general terms, it is referred to as the portion of production after cost oil and royalty is deducted that is shared between the IoC and HG. The division of profits between the IoC and the HG is generally referred to as '*contractor/government take*'.[80] Most PSC's usually allot the profit petroleum in percentage fashion. The percentage of profits which is due to the IoC is referred to as contractor take while the percentage share of net profits due to the HG in a fiscal regime is referred to as government take.[81]

It is normally measured over the life of the project hence representing the aggregate share.[82] In other terms, where the NoC of a HG is involved in or has been nominated to be a participant in the PSC, then the NoC receives the share of profit petroleum on behalf of the HG in the venture. The mode of payment of the profit petroleum can either be paid in cash or 'in kind' as prescribed in a PSC to the HG or an entity that it nominates, usually a NOC.[83] Worth noting is that whether the oil is taken in kind or cash does not affect either fiscal regime but it's a mere representation of the modality of profit petroleum. [84]

Profit petroleum does not form part of the royalty and other taxation that have been incorporated in the PSC, essentially it's a representation of the HG share that is usually excess of the prescribed cost recovery amounts in the PSC in a normal production quarter.[85] Where the HG have well developed infrastructures especially a local refinery and proper retailing operations, such HG will prefer oil in kind rather than in cash in order to be able to meet the domestic market while HG lacking refinery and infrastructure especially proper retailing operations will prefer to take their share of oil in cash. The choice of whether to take profit petroleum in kind or cash is pegged on HG's goal and the prevailing infrastructure it has put in place.[86]

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[80] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.
[81] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts*.
[82] Daniel P *et al Technical notes on Extractive Industries Fiscal Regimes.*
[83] Committee of Experts on International Cooperation in Tax Matters, Production Sharing Contracts,' in United Nations, *Handbook on selected issues for Taxation of Extractive Industries by Developing Countries*,Newyork,2020, 19.
[84] Daniel P et al *Technical notes on Extractive Industries Fiscal Regimes.*
[85] Anderson L, Weaver J, Dzienkowski J, Lowe J, Hall K and Sourgens FC, *International Petroleum Law and Transactions, Rocky Mountain Mineral Law Foundation*,U.S,4th Edn, 2020,306.
[86] Anderson L *et al,International Petroleum Law and Transactions*,307.

2.4 **Ring fencing**

Ring fencing is defined as '*fiscal boundary within which costs and revenues of companies in common ownership may be consolidated for tax purposes*.'[87]In essence, it is a fiscal concept in PSC's especially under cost recovery calculations where costs incurred from one contract development area are not used to offset costs from other contract development areas by the same company.[88]Generally, an IoC's preference would be to cluster costs and profits together generated from the same development area thereby not applying ring fencing rules to their operations. However, HG's prefer separating costs and profits from each reservoir block separately in order to have a line of sight for each development area.[89]

Normal practice in the oil and gas sector is for an IoC to develop numerous commercial fields as they seek to find additional hydrocarbon for production purposes and this venture usually has a resultant cost implication on the IoC. The costs incurred in different commercial fields within the same contract area are separated for the simple reason that not all wells sunk within a contract area, during the search for additional hydrocarbons, results into profitable hydrocarbon production or simply put, some wells may not be commercially productive as others.[90]

An IoC will always attempt to recover most costs, if not all, by attempting to offset costs from marginal fields against productive fields with higher profit margins thereby mitigating their expenditure.[91]This act has a direct impact on profitability and the resultant share a HG obtains. Therefore, to avert this, ring fencing of costs is introduced so that costs incurred in one commercial field is not used to offset costs incurred in another commercial field especially within the same contract area. Ring fencing can be broadly categorized into block ring fencing rules and reservoir ring fencing rules.[92]

Block ring fencing rules imputes that oil produced from a contract area cannot be used to offset against costs incurred in a different block area held by the same IoC.[93] Ideally, each block deals with its own costs incurred within it. For example, if a dry well was sunk in the north west corner of block A, while the south west corner of block B produced a commercially viable well, then the costs incurred in sinking the dry well during exploration cannot be recovered

[87] International Monetary Fund, *Fiscal Regimes for Extractives Industries: Design and Implementation*, (2012).
[88] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*, 88.
[89] Anderson L *et al,International Petroleum Law and Transactions*,353.
[90] Anderson L *et al, International Petroleum Law and Transactions.*
[91] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*,2013, .
[92] Anderson L *et al, International Petroleum Law and Transactions*,354
[93] Anderson L *et al, International Petroleum Law and Transactions.*

against the oil discovered in the commercially productive well in the south west corner of block B.

Reservoir ring fencing, on the other hand, implies that costs incurred in one reservoir within a block in a contract area cannot be used to offset against oil produced in another reservoir in the same block within the contract area.[94] Illustrated as, a contractor in block A drills two reservoir wells in block A within the same contract a few kilometers apart. One of the drilled wells proves to be dry while the other proves to be commercial in nature. Then, reservoir ring fencing implies that the costs incurred in drilling the dry well above is not recoverable against the commercially viable reservoir drilled within the same block A. In certain circumstances however, the HG may allow exploration costs incurred in failed blocks where within a contract area where oil is produced in order to encourage the IoC to explore new areas and reinject capital into the Country.[95]

Worthy to note that ring fencing does not only apply to cost recovery for IoC's but it is also an important fiscal term to a HG when it is computing its taxation such as income tax. Further, ring-fencing is important where a resource straddles two or more blocks that is contracted by different parties.[96]

Ring fencing as a concept applies to both the R-factor and DROP fiscal regime.[97] Both fiscal regimes can adopt either the block ring fencing or reservoir ring fencing as stipulated in the PSC.[98] While doing so, under both regimes, the applicability of ring fencing shall be determined on the development area or the contract area depending on the wording of the PSC.[99] However, the difference between the two-fiscal regimes as regards the applicability of ring fencing arises from the truncating from one level to the next level. For example, under the DROP fiscal regime in Kenya, the repealed model PSC does not provide for ring fencing of costs. Under the model PSC, 2019, it provides for ring fencing and its block ring fencing in its very nature.[100]

[94] Anderson L *et al, International Petroleum Law and Transactions.*
[95] Anderson L *et al, International Petroleum Law and Transactions,*310.
[96] Under this, it would lead the parties to 'unitize' the blocks for purposes exploiting such resource.
[97] Anderson L *et al, International Petroleum Law and Transactions.*
[98] Anderson L *et al, International Petroleum Law and Transactions.*
[99] Anderson L *et al, International Petroleum Law and Transactions.*
[100] Clause 36(2)(j) provides that..' the petroleum costs under the contract are not recoverable against other contract areas held by the contractor in Kenya.'

2.5 **Daily Rate of Production (DROP**)

A fiscal regime that is based on daily rate of hydrocarbon produced that is allocated based on an average daily rate of production over a specified time frame (normally one year being a production year) with the HG receiving an increased share of hydrocarbon as the average daily rate of production increases through a pre-defined band.[101]

In order for DROP to be profitable to the HG, it requires additional fiscal instruments to capture windfall profits[102] as a result of global market prices. Some DROP fiscal regimes use total revenue as a base for calculation of profit share, in this circumstance, it does not factor profitability directly hence not flexible where prices or volumes vary over time.[103]

Tranche of Daily rate of profit petroleum(b/d)	**Corresponding Government share**	**Government Share Per tranche(b/d)**	**Amount of profit petroleum (b/d)**	**Profit petroleum to Government (b/d)**	**Effective Government share**
A	B	AxB	C	D	D/C
First 20,000	55%	11,000	20,000	11,000	55%
Next 30,000	60%	18,000	50,000	29,000	58%
Next 50,000	63%	31,250	100,000	60,250	60%
Next 50,000	68%	34,000	150,000	94,250	63%
Above 150,000	78%	39,000	200,000	133,250	67%

Above is an illustration of DROP [104]

A challenge to this is that it does not allocate profit petroleum based on the direct measure of project profitability but rather it premises it on the production volumes. This presents a challenge where capital and operating costs of projects are high and the volumes of hydrocarbon produced are equally high but the market prices are low hence contractors' cost

[101] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*,202.
[102] Refers to the excess profit or cash inflow arising from the unforecasted or sudden increase in market price of a commodity.
[103] Beardsworth and Husbands , *Kenya Oil and Gas Sector Development*,97.
[104] Daniel P *et al Technical notes on Extractive Industries Fiscal Regimes*.

recovery may take a while where the HG is also entitled to a larger share of profit petroleum. Conversely, where production volumes are all time low but profitability high (for example caused by high market prices), the DROP regime may not capture a fair share of government return unless it provides for such through provision of windfall profits due to increase in market price of crude.[105] In essence, the defining feature of the DROP fiscal regime is that it is based on production volume rather than *value* of the production. Hence it does not capture an increase in *value* that is unrelated to production volume, such as in the case of a global commodity price spike.

2.6 **R-Factor**

R-factor is a way of making fiscal terms of a HG more progressive in the sense that the higher the rate of profitability, the more the HG share increases.[106] The R-factor is a fiscal revenue share that compares cumulative project revenues to cumulative costs. The cumulative revenue is divided by cumulative costs in order to provide the value of R-factor.[107] From this, R-factor determines how the share of profit is allocated between the HG and the IoC. R-factor is regarded as highly progressive especially to HG as it captures profitability in an investment as it does not require additional fiscal terms such as windfall and royalty to tighten Government's share of profit.[108]

It is normally designed in a manner that allocates a higher proportion of profit petroleum to HG in instances where the project becomes profitable. The basis of profit petroleum share is on the rate of return a contractor achieves that is pegged on cumulative net cash flow. Profit petroleum share is on a ratio of cumulative net cash inflow against cumulative cash outflow.[109] It is designed to generate petroleum revenue in three batches.[110]

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[105] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[106] Anderson L *et al, International Petroleum Law and Transactions*,312.
[107] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*,98.
[108] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*,99.
[109] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[110] KIPPRA, A *comparative study of oil producing countries and petroleum revenue sharing models: lessons for Kenya*, 2018.

R-factor is often tabulated as;[111]

R-Factor	Government's share	Contractor's share
Less than 1.0	**50%**	**50%**
Equal to or greater than 1.0 and less than 2.5	**65%**	**35%**
Equal to or greater than 2.5*	**(75)%**	**(25)%**

Firstly, when the R-factor is less than 1, it implies that the cumulative project costs have exceeded the cumulative revenues generated from the project. This implies that the project is making a loss.[112] This would be construed that the project is in its initial phase where costs such as exploration, appraisal, development capital costs and production costs are being incurred.[113] In this level, the HG take is kept at a minimal level as provided for in the PSC.

Secondly, when the R-factor is equal to 1, it implies that cumulative project costs is equal to revenue generated from the project. This indicates that some revenue has been generated sufficiently to equate to the costs incurred.[114] The HG take will increase under this phase as provided for in the PSC. Thirdly, assuming that IoC's forecasts holds true, where the R-factor is greater than 1, it implies that cumulative revenue generated by the project is more than the project costs hence a profitability.[115] The HG take will further increase accordingly as per the terms of the PSC.

R-factor is formulated as $R= X \div Y=$ *cumulative cash inflows* $\div$ *cumulative cash outflows*[116]

The simplicity in auditing of costs as provided for vis a viz the revenue generated is pretty straight forward under this regime in light of the specific costs indicated as recoverable and in what order. The only upshot to this is that, auditing such costs require thoroughness since the costs have a direct impact on the value of R-factor. It is viewed as a more progressive regime as it factors the market price shift in pricing and is able to capture any windfall margins that may arise during a production year and also reduces IoC risks on the downside of low market

[111] Clause 37, Kenya's Model Production Sharing Contract,2019.
[112] Anderson L *et al, International Petroleum Law and Transactions.*
[113] Anderson L *et al, International Petroleum Law and Transactions,*312.
[114] Anderson L *et al, International Petroleum Law and Transactions*.
[115] KIPPRA, *A comparative study of oil producing countries and petroleum revenue sharing models: lessons for Kenya,* 2018.
[116] Clause 37(1) Model Production Sharing Contract,2019.

prices. Further, it is a more certain regime in that it covers the return on investment within a single fiscal framework and any subsequent changes such as change in taxation rate or additional of such can be avoided. It is also responsive to economic factors such as price, costs, volume, location and quality without requiring additional information for assessment and monitoring.[117]Hence, the HG does not have to enact additional tax measures such as windfall tax regimes in order to benefit from sudden change in circumstance in the global market.

The main challenge in this fiscal regime is that the approach does not consider time value of money within the profit share calculation although such can be captured through a higher rate of cost recovery which in essence would lower the HG share of profitability.[118]

2.7 **Stabilization Clauses**

Historically, stabilization clauses can be traced as early as 1920s when it was used to reduce political risks and preserve contracts between a HG and IoC.[119] The basis for the incorporation of such clauses arose due to the fear of expropriation and nationalization of assets by HG.[120]A key function of long-term investment contracts is to facilitate trade and to safeguard investments of the parties so that they can be able to undertake their respective obligations under the contracts in order to achieve the economic gains intended.[121]

Stabilization clauses are oftenly negotiated with the State or State Entity mandated to administer natural resources on behalf of the public.[122] In the *Liberian Eastern Timber Corporation vs Republic of Liberia*, the ICSID tribunal opined that

> '….*a Stabilization clause is commonly found in long term development contracts and,.. is meant to avoid the arbitrary actions of the contracting government. This clause must be respected especially in this type of agreement. Otherwise, the contracting State may easily avoid its contractual obligations by legislation. Such legislative action could only be justified by nationalization*.'[123]

To achieve this, IoC's shield themselves through the contractual and regulatory provisions that insulate them against the uncertain circumstances in the oil and gas sector.[124] Investors with

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[117] Daniel P *et al Technical notes on Extractive Industries Fiscal Regimes*, 9.
[118] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*, 4.
[119] Emeka J,'Anchoring Stabilization Clauses in International Petroleum Contracts' *The International Lawyer* (2008), 1317.
[120] Siloko P, 'Contractual stabilization in international petroleum agreements: what is its validity and function?'
[121] Siloko P, 'Contractual stabilization in international petroleum agreements: what is its validity and function?'
[122] Bernardini P,' *Stabilization and adaptation in the oil and gas investments*,100.
[123] *Liberian Eastern Timber Corporation v. Republic of Liberia,* ICSID Case No. ARB/83/2 ,666-7.
[124] Such circumstances range from change in market risks that deals in oil prices dropping, geological risks, political risks within the HG's among others.

long term contracts with developing countries often perceive exceptions to *pact sunt servanda* as risks that are less predictable to the contract.[125]

In light of this perception and the weakening of commitments to the contract, special clauses aimed at freezing the contractual obligation or terms over the execution phase known as stabilization clauses are developed.[126]Stabilization clauses play a key role in risk mitigation in that it protects investments from 'sovereign or non-commercial' risks such as change in law, expropriation or nullification of contracts as a result of national laws among other factors.[127]

The above risks are equally shared by third parties such as lenders or financiers who are desirous of seeing contractual stability as a prerequisite for bankability of a commercial agreement.[128]

The underlying basis of such clauses is to shield the investment from arbitrary steps that a HG can take which might negatively impact the investment and offer comfort in that the investment conditions will be guaranteed hence return on investment.[129] Conversely, such clauses also act as incentives to attract investments into the HG in a competitive petroleum environment.[130] For example, when petroleum market prices are low or when exploration and development costs of a HG are high as compared to neighboring states with similar prospects, a HG can incentivize the IoC through providing stabilization on the investment in order to prevent investors going to invest in a neighboring Country.

In as much as the investor's rights have to be taken care of and factored, the HG's interest is vital and requires protection so that it fits into the ever-changing economic reality. As a result, the conflicting economic interests between IoC and HG are inevitable.[131]Due to the competing and ever evolving economic interests of the parties as a result of the unforeseen circumstances not contemplated in the HGI, it has occasioned instability which is a backbone to IoC's legitimate expectation in investment contracts.[132] As Maier B observes,[133]

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[125] Bernardini P,' *Stabilization and adaptation in the oil and gas investments*,100.
[126] Cameron P, *Stabilization in investment contracts and changes of rules in host countries: tools for oil and gas investors*,(Association of International Petroleum Negotiators),2016.
[127] Lukanda F,'Renegotiating investment contracts: the case of mining contracts in Democratic Republic of the Congo,' *George Mason International Law Journal* (2014),7.
[128] Lukanda F,*Renegotiating investment contracts.*
[129] Lukanda F,*Renegotiating investment contracts.*
[130] Lukanda F,*Renegotiating investment contracts.*
[131] Bernardini P,' *Stabilization and adaptation in the oil and gas investments.*
[132] Maier B, 'How has international law dealt with the tension between sovereignty over natural resources and investor interests in the energy sector? Is there a balance? ',4 *International Energy Law Review*, (2010),103.
[133] Maier B, 'How has international law dealt with the tension between sovereignty over natural resources and investor interests in the energy sector? Is there a balance? ',96.

> ‘*In this increasingly interdependent energy world, there is a wide variety of divergent interests involved in the extraction of resources. States … seek maximum flexibility in extracting, refining and selling the resources present within their territory so as to be able to make the most of the current market conditions as well as to be able to adapt to the political sentiment prevalent at any given time. Investors, on the other hand, being actors in an exceptionally long-term and capital-intensive industry, desire reliable, consistent and transparent legal frameworks so as get the maximum possible return on their investment.’*

From the foregoing, inserting a stabilization clause in a HGI becomes apt and it is considered a key feature in most HGI.[134] The essence of a stabilization clause is to provide assurance to an IoC that the HG will not arbitrarily change its applicable law, regulations or fiscal terms such that it will substantially affect the IoC’s contractual expectations.[135] It insulates the IoC from such changes therefore protecting them from obsolescing bargain where the likelihood of HG assuming no exploration risk will come and regard the HGI as unfavorable to itself especially on the fiscal terms prompting it to increase its stake in the HGI through levying a special tax on the petroleum.[136]

From the purview of an IoC, the stabilization is important as it prevents the HG from adverse actions.[137] Secondly, such a provision promotes a negotiated resolution of disputes where HG despite the deterrent power of HGI provisions, they proceed to exercise their legislative and executive prerogative orders that overshadow the contractual rights arbitrarily.[138] In such circumstances, the stabilization clauses mitigate losses that accrue to the investor. Thirdly, if the IoC is to seek legal redress arising from such HG actions, it is often through the international tribunals as normally highlighted in the dispute resolution clause of the HGI. Such tribunals will enforce stabilization commitments that are granted by HG unless the stabilization clause was equivocal or a party waived its rights under the stabilization clause.

[134] Dumbery P,*’International Investment Contracts*’ in Gazzini T and Brabandere E, *International investment Law: the Sources of Rights and Obligations,* Martinus Nijhoff, 2012,221.
[135] Anderson L *et al, International Petroleum Law and Transactions*,475.
[136] Anderson L *et al, International Petroleum Law and Transactions,476.*
[137] Cameron P, *Stabilization in investment contracts and changes of rules in host countries: tools for oil and gas investors*.
[138] Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries.*

Fourthly, stabilization clause, reinforces HG obligations under international investment treaties through documenting the IoC's legitimate expectation when contracting with the HG or through triggering a right enshrined in the investment treaty that protects the IoC.[139]

Stabilization clause takes three major forms: freezing clause, economic stabilization and the hybrid clause.[140] The freezing clause seeks to fix or freeze for the term of the project the applicable domestic legislation or regulations affecting the project to those in effect as of the date of the HGI.[141] Under this clause, legislations adopted after the effective date of the HGI do not apply to the foreign investors or the project unless the investors expressly agree to such changes.[142] The economic equilibrium refers to changes in law occurring after the execution of the HGI and apply to the project and its foreign investors except that the host government must usually indemnify the investors from and against the costs of complying with the new laws.

The economic stabilization clause mandates the HG not to make any changes in law or fiscal regime that would negatively impact the Agreement. However, where the HG makes such changes, it shall be compelled to renegotiate the terms of the Agreement in order to restore the IoC back to the economic position it was prior to the change in law.[143] These clauses are intended to preserve the economics of the project. The scope of the HG's indemnification obligation depends on the negotiating strength of the parties and the host government's need for the proposed investment.[144] Additionally, such a clause, more often than not, works in a singular dimensional fashion in that it only benefits the IoC rather than the HG in circumstances where a change in law occurs. For example, where a HG would reduce its corporate income tax percentage, an IoC may not proceed to compensate the HG for such changes.

2.7.1 **Economic Equilibrium Clause**

Renegotiation of contracts as a management tool in the international contractual sphere came about as a result of the growing imbalance and inequality between the investors and HG endowed with natural resources.[145] Generally, investors to any commercial contract look for

[139] Bowman P, 'Risk mitigation in international petroleum contracts,' 50 Georgetown Journal of International Law (2019),12-1.
[140] Gehne K and Brillo R, 'Stabilization Clauses in International Investment Law: Beyond Balancing and Fair and Equitable Treatment'.
[141] Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries,*12.
[142] Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries.*
[143] Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries*.
[144] Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries*.
[145] The post-colonial reality of long-term concession contracts awarded by colonial regimes to companies connected with such colonial masterminds paid no regard to the interests of the Host Government. With the growing acceptance of the principle of permanent sovereignty over natural resources as a fundamental

stability in the massive upfront investment put in place, HG aim at controlling and obtaining the maximum returns over the natural resources they are endowed with.[146] This divergent yet important positions have been exacerbated by increase in revenues/profits by the natural resources triggering the conversation of the need to relook at contractual relationships in light of the windfall profits generated.[147]

As a rule of thumb, freezing clauses that entirely prohibit any changes in legislation and fiscal policies do hinder HG from imposing robust laws and legislations in the exercise of their sovereignty.[148]Moreover, the enforceability of such provisions comes into question as a HG may have difficulty in the implementation and management of HGI with varied effective dates since each one might be subjected to its individual set of taxation, laws and regulation.[149]

Henceforth, the economic equilibrium allows the HG to make changes to its laws and regulations. It does not entirely stabilize the contract rather provides insulation to the economics of the investment in entirety. The clause provides that the HG may change its law, legislation and taxation regime as it wishes as long as it has an impact on the economics of the project that affects the IoC will trigger a renegotiation in order to mutually benefit the parties economically.[150]

An economic equilibrium provision does not stop the enactment of new laws or fiscal regimes from governing existing HGI, what it simply seeks to achieve is that in the event of a material or adverse change which impacts on the IoC, the later can trigger a renegotiation or adjustment of the contract to restore equilibrium as between them and the HG prior to such changes occurring.[151]

Economic stabilization clause can re-establish the economic equilibrium of a HGI through three broadly classified categories namely (i) Stipulated Economic Balancing (SEB), (ii) Non-specified Economic Balancing (NSEB) and (iii) Negotiated Economic Balancing (NEB).[152] As discussed below, it is worth noting that different stabilization clauses have different legislative

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component of the rights of people to self-determination (Article 1 of the International Covenant on Civil and Political Right), these concessions came under a lot of scrutiny.

146 AFM Maniruzzaman, 'The Issue of Resource Nationalism: Risk Engineering and Dispute Management in the Oil and Gas Industry' *Texas Journal of Oil, Gas, and Energy Law* (2009)..

147 Anderson L *et al, International Petroleum Law and Transactions*.

148 Anderson L *et al, International Petroleum Law and Transactions*,483.

149 AFM Maniruzzaman, 'The Issue of Resource Nationalism: Risk Engineering and Dispute Management in the Oil and Gas Industry.

150 Anderson L *et al, International Petroleum Law and Transactions,484.*

151 Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries*.

152 Maniruzzman AFM, 'The pursuit of stability in international energy investment contracts: A critical appraisal of the emerging trends' Vol.1,*Journal of World Energy Law Business* (2008),127.

trigger events that will lead to renegotiation. To begin with, under the SEB, it provides for the automatic amendment of the HGI in a specified manner where changes in law or regulations are undertaken by the HG that affect the HGI. For example, the Ecuadorian Model PSC provides that,

> ‘ *In case of modification to the tax regime, including the creation of new taxes, or the labor participation, or its interpretation, that have consequences on the economics of this Contract, a corresponding factor will be included in the production share percentages to absorb the increase or decrease in the tax burden or in the labor participation of the previously indicated contractor. This correction factor will be calculated between the Parties and approved by the Ministry of Energy and Mines*.’[153]

In this context, the SEB is so specific to the changes that would trigger a re-negotiation of the production share and how the parties are able to undertake the changes accordingly.

The second category being NSEB although providing for an automatic amendment to the HGI it does not expressly provide for the specific nature of amendment nor the mutual agreement of the parties for the amendment. For example, under the Azerbaijan PSC provides that,

> ‘*In the event that any Governmental Authority invokes any present or future law, treaty, intergovernmental agreement, decree or administrative order which contravenes the provisions of this Agreement or adversely or positively affects the rights ot interest of Contractor hereunder, including, but not limited to, any changes in tax legislation, regulations, or administrative practice, the terms of this Agreement shall be adjusted to re-establish the economic equilibrium of the Parties, and if the rights or interest of Contractor have been adversely affected, then SOCAR shall indemnify the Contractor(and its assignees) for any disbenefit, deterioration in economic circumstances, loss or damages that ensue therefrom. SOCAR shall within the limits if its authority use its reasonable lawful endeavors to ensure that the appropriate Governmental Authorities will take appropriate measures to resolve promptly in accordance with the foregoing principles any conflict or anomaly between all such treaty, intergovernmental agreement, law, decree or administrative order and this agreement.*[154]

[153] Article 11.7, Model Production Sharing Contract 2002.
[154] Article 24.2 Production Sharing Contract between State Oil Co. of Azerbaijan and Kura Valley Development Co Ltd, 1999.

The third category being NEB mandates the parties to meet and negotiate the amendments to the contract. The Indian Model PSC provides that

> 'If *any change in or to any Indian law, rule or regulation imposed by any central, state or local authority dealing with income tax or any other corporate tax, export/import tax, customs duty or tax imposed on petroleum or dependent upon the value of petroleum results in a material change to the economic benefits accruing to any of the Parties after the Effective date, the parties to this contract shall consult promptly to make necessary revisions and adjustments to the Contract in order to maintain such expected economic benefits to each of the Parties as of Effective Date*.'[155]

Kenya has also adopted a NEB clause through the Model Production Sharing Contract of Kenya (2019), which provides that,

> 'If *after the effective date of this contract the economic benefits of a party are substantially affected by the promulgation of new laws and regulations, or of any amendments to the applicable laws and regulations of Kenya, the parties shall agree to make the necessary adjustments to the relevant provisions of this contract, observing the principle of the mutual economic benefits of the parties*.'[156]

A similar provision is incorporated under the various PSC's signed by the Government of Kenya.[157] From the IoC's standpoint, such provisions provide flexible and more advantageous terms than the claim for damages for breach arising from a traditional clause.

In order to protect the IoC, a renegotiation clause should provide the following conditions. Firstly, it should have a trigger event that ordinarily affects the IoC's economic benefits or rights. Secondly, that it provides for a mandatory procedure on renegotiation in response to the trigger event above. Thirdly, that an effective statement that the economic benefits are restored and lastly provide a recourse to international arbitration where parties cannot reach an agreement.[158]

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[155] Article 16.7 Indian Model Production Sharing Contract.
[156] Clause 52(3), Model Production Sharing Contract,Kenya.
[157] Clause 40(3), Production Sharing Contract for Block 10BB between Government of Kenya and Turkana Drilling Consortium Ltd as read with Clause,40(3) Production Sharing Contract,Block 13T between Government of Kenya and Platform Resources Inc.
[158] Bowman P,*'Risk mitigation in international petroleum contracts'*,766.

An illustration of all the above elements is well captured in a Nigerian PSC between Nigerian National Petroleum Corporation and Esso Exploration and Production Nigeria Limited which provides that

> *‘ In the event that any enactment or of change in the laws or regulations of Nigeria or any rules, procedures, guidelines, instructions, directives or policies, pertaining to the contract introduced by any Government department or Government parastatals or agencies occurs subsequent to the effective date of this contract which materially and adversely affects the rights and obligations or the economic benefits of the Contractor, the Parties shall use their best efforts to agree to such modifications to this Contract as will compensate for the effect of such changes. If the Parties fail to agree on such modifications within a period of ninety (90) days following the date on which the changes in question took effect, the matter shall thereafter be referred at the option of either party to arbitration under Article 21 thereof. Following (the) arbitrator’s determination, this Contract shall be deemed forthwith modified in accordance with that determination.*’[159]

A challenge with economic equilibrium is whether the clause is a little more than an agreement to agree which leads to long and failed negotiations. This in turn affects the enforceability specifically common law jurisdiction while in the civil law jurisdiction parties are obligated to an implied duty of renegotiation in good faith. Such a stalemate would be resolved through an expert determination or at a principal level by the senior management.[160]

2.7.2 Essence of stabilization

Stabilization has several usefulness that is attached to it. Firstly, it serves as a financial basis for IoCs in that they peg their financial models on the stability of a HGI. [161]Stabilization ensures that IoCs are able to properly model the investment and guarantee the investments will be recouped in light of the conditions the investments were made. Any breach or interruption to such economic conditions guarantees the IoC a compensation to its investment through the stabilization clause.[162]

Secondly, stabilization clauses aid in foreign direct investments. Investors look at the risk profiles of HG before making an investment decision. Where the risk profile is high but a

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[159] Production Sharing Contract between Nigerian National Petroleum Corporation and Esso Exploration and Production Nigeria Limited(1993).
[160] Bowman P,*’Risk mitigation in international petroleum contracts’*,770.
[161] Bowman P,*’Risk mitigation in international petroleum contracts’.*
[162] Siloko P, ‘*Contractual stabilization in international petroleum agreements’.*

guarantee of the investment is not being interfered with or changed, the investors will inject investment into such a HG. Finally, stabilization seeks to increase IoCs confidence in the HG. The IoC knowing and having the guarantee that the investment will be certain and, in any event it is changed, they are compensated for such losses will increases their confidence in investing in the HG.[163]

In essence, the economic stabilization clause counterbalances the HG's sovereign prerogative to change its laws or amend them when the same have a direct impact on the long-term investment contract under execution while opening up the door for a renegotiation between the parties.[164]

[163] Siloko P, '*Contractual stabilization in international petroleum agreements'*.
[164] Siloko P, '*Contractual stabilization in international petroleum agreements'*.

Chapter Three: COMPARATIVE STUDY OF KENYA'S AND MOZAMBIQUE'S PROFIT PETROLEUM FISCAL REGIME

3.1 **Introduction and Background**

As discussed in chapter 2 above, the key principles that underpin any profit petroleum fiscal regime are the cost recovery limits, the ring fencing of costs, the profit petroleum and stabilization clause as stipulated in the PSC or concession. In as much as Mozambique and Kenya have different contractual frameworks governing their hydrocarbon activities, namely a concession and a PSC respectively, there are striking similarities as regards the profit petroleum sharing in their fiscal regime.

This chapter looks at Kenya's and Mozambique's profit petroleum fiscal regime especially with a view on the R-factor and stabilization clause. The first part of the chapter evaluates Kenya's legal framework that governs profit petroleum fiscal regime. The second part of this chapter evaluates Mozambique's profit petroleum fiscal regime while making a comparison to that of Kenya. In the same vein, it will identify the similarities and gaps therein.

3.2 **Kenya's legal framework governing profit petroleum fiscal regime.**

3.2.1 **The Constitution of Kenya, 2010**

With the GoK discovery of hydrocarbon deposits in Kenya and the potential of being an oil export hub, it triggered conversations of natural resource management in Kenya.[165] It was observed that it could provide a unique path for sustainable economic growth and avert resource curse as witnessed in other African countries.[166] This necessitated a raft of changes to be made in the constitution and other governing laws around natural resources as discussed below. The discourse around natural resources in Kenya and the resultant custody by the State on behalf of the People of Kenya is traced to the Constitution of Kenya and the Petroleum Act.[167] It states that when the State grants the right or concession as regards to the exploitation of any natural resources it shall ensure the sustainable exploitation, utilization and conservation of the natural resources while ensuring equitable sharing of accruing benefits.[168] Worthy to note is that the Constitution of Kenya does not expressly provide for how the division of profit

[165] Vasquez P, 'Kenya at a crossroads:Hopes and fears concerning the development of Oil and Gas reserves' *International Development Policy(2013).*
[166] Vasquez P,' Kenya at a crossroads'.
[167] Art.62(3) Constitution of Kenya,2010 and Sec.14 Petroleum Act No.2 of 2019.
[168] Constitution of Kenya, Article 62(3) as read with Article 69(1)(a), Article 71(1)(a) and Sec.14(1) Petroleum Act vests property in petroleum on the National Government.

petroleum between the HG and the IoC's is conducted however it mandates the State to ensure the equitable sharing of the accruing benefits in accordance with Article 169(1)(a).

3.2.2 **The Energy Act of 2006.**[169]

Prior to the promulgation of Constitution of Kenya,[170] the petroleum legal framework of Kenya was administered under two Acts of Parliament.[171] The Energy Act provided for the midstream and downstream functions of the petroleum sector such as importing, transporting, refining, storing and selling of petroleum or petroleum products,[172] while the repealed Petroleum Act[173] provided for the negotiation and conclusion of Petroleum agreements relating to exploration, development, production and transportation.

3.2.3 **Petroleum (Exploration & Production) Act of 1986.**[174]

The framework under CAP 308 adopted a PSC where an IoC would be granted a license for exploration and production while Government would be entitled to a proportion of the oil produced after the relevant costs were deducted.[175]

The petroleum legislation of most Countries often includes a Model HGI with it that is used as a base to develop the relevant HGI a Country would use to exploit its natural resource.[176] The subsequent Model HGI once executed by the parties, it changes its form to be a legally binding contract often in the form of a PSC, a Service Agreement or Risk Service Agreement.[177] In the Kenya context, the HGI is a Model Production Sharing Contract (Model PSC) that is used to guide the development of a relevant HGI as between Kenya and an IoC. Under Kenya's legal framework, the now repealed Model PSC's were published in 1986, 1999 and 2008.[178]

The Government of Kenya (GoK) and the respective IoC's namely Camac Energy, Platform Resources Inc., Turkana Drilling Consortium Kenya to mention but a few proceeded to execute the Model PSC's which have turned out to be the existing PSC's governing the relationship between the GoK and the IoC's.[179]

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[169] Energy Act of 2006 CAP 314.
[170] Promulgated on 27th August,2010.
[171] The Petroleum (Exploration and Production) Act of 1986 CAP 308 and the Energy Act of 2006 CAP 314.
[172] Section 3, Energy Act,2006(repealed by Energy Act, No.1 of 2019).
[173] CAP 308 (Repealed by Petroleum Act, 2019 No.2 of 2019).
[174] The Petroleum (Exploration and Production) Act of 1986.
[175] The Extractives Policy Working Group,' Revenue Sharing and Management in Kenya's Petroleum Sector,' Technical paper No.1, 2018,5.
[176] Anderson L *et al, International Petroleum Law and Transactions.*
[177] Anderson L *et al, International Petroleum Law and Transactions.*
[178] The Extractives Policy Working Group,' Revenue Sharing and Management in Kenya's Petroleum Sector,'5.
[179] Production Sharing Contract between Camac Energy Ltd & Government of Kenya relating to Block L1B, Production Sharing Contract between Turkana Drilling Consortium Ltd & Government of Kenya relating to

Although the Model Production Sharing Contract, 2008 (repealed Model PSC) was repealed by the enactment of Petroleum Act 2019, which subsequently incorporated a new Model Production Sharing Contract 2019, the existing PSC's due to the longevity of their contractual life, are still operational and maintain the terms which the parties negotiated them under the repealed Model PSC.[180]

The repealed Model PSC mandates the Contractor to produce petroleum at a maximum efficient rate in accordance with good international petroleum industry practice[181] which would enable Kenya attain maximum production of its crude.

Under the cost recovery regime of the repealed Model PSC, the contractor is entitled to recover petroleum (cost oil) in respect of all petroleum operations they incurred at a percentage in a fiscal year and to be negotiated during contracting.[182] The cost oil is recoverable in the following manner;[183]

a) Petroleum Costs-except capital expenditures incurred. These are recoverable within the same fiscal year incurred or production occurred.
b) Capital expenditure in respect of each development area recovered at twenty percent (20%) per annum.

Accordingly, such cost oil recoverable is deemed to be quiet generous terms to the IoC's which in turn will affect Government's share of profit petroleum due from the venture.[184]

The repealed Model PSC mandates the Contractor to endeavor to produce in each calendar year the forecasted quantities as estimated in the annual production programme[185] hence production is pegged on volumes of crude oil.

The repealed Model PSC provides that where petroleum costs recoverable, as enumerated above, exceed the value of cost oil for that final year, the excess of such shall be carried forward for purposes of recovery.[186] Conversely, where costs recoverable are less than the minimum value of cost oil as specified, the excess shall be provided as profit petroleum.[187] It

Block 10BB., Production Sharing Contract between Platform Resources Inc & Government of Kenya relating to Block 13T.
[180] Section 128,Petroleum Act(No.2 of 2019).
[181] Clause 24(1) Model Production Sharing Contract,2008.
[182] Clause 27(1) Model Production Sharing Contract,2008.
[183] Clause 27(2)(c),(d) and (3) Model Production Sharing Contract,2008.
[184] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development.*
[185] Clause 24(3) Model Production Sharing Contract,2008.
[186] Clause 27(2)(c) Model Production Sharing Contract,2008.
[187] Clause 27(2)(d) Model Production Sharing Contract,2008.

further provides that 'profit petroleum' is that total crude oil produced and saved from contract area and not used in petroleum operations to which the cost oil is removed shall be referred to as 'profit petroleum' and shall be shared between the Government and Contractor in an incremental form as;[188]

Increments of Profit petroleum As to oil produced offshore	***Government share***	***Contractor's share***
First 20,000 Barrels per day	%	%
Next 30,000 Barrels per day	%	%
Next 50,000 Barrels per day	%	%
Any volume over first 100,000 Barrels per day	%	%

In this regime, profit petroleum is calculated in consideration of total crude oil production from the contract area that is subtracted from cost oil.[189]

Additionally, the repealed Model PSC provides for other reasonable expenditure not covered or dealt with in the foregoing provisions that are incurred by the operator and its affiliates for the necessary, proper, economic and efficient conduct of petroleum operations.[190] The other expenditure is the interest on loans raised by the contractor for capital expenditure in petroleum operations under the contract at a rate not exceeding prevailing commercial rates recoverable as petroleum costs.[191]

As regards the stabilization clause, it provides that,

> '*if after the effective date of the Contract the economic benefits of a party are substantially affected by the promulgation of new laws and regulations, or of any amendments to the applicable laws and regulations, the parties shall agree to make the necessary adjustments to the relevant provisions of the contract while observing the principle of mutual economic benefits of the parties*.'[192]

[188] Clause 27(3) Model Production Sharing Contract,2008.
[189] Clause 27(2)(d) Model Production Sharing Contract,2008.
[190] Clause 2.1.2 Appendix B- Accounting Procedure- Model Production Sharing Contract,2008.
[191] Appendix B,2.12.1 and 2.12.2 repealed Model Production Sharing Contract,2008.
[192] Clause 40(3) Model Production Sharing Contract,2008.

This is a component of the economic equilibrium where the parties can mutually renegotiate the contentious provisions of the contract that have been affected by the promulgation of a new law or regulation accordingly.

3.2.4 **The Petroleum (Exploration, Development and Production) Act 2019.**

This is the current legislative framework that governs the contracting, exploration, development and production of petroleum in Kenya and equally repealed the Petroleum (Exploration and Production) Act[193] which previously governed petroleum operations in Kenya.

The legislation is more comprehensive and updated compared to its outdated predecessor in that it has attempted to regulate and operationalize the upstream, midstream and downstream sectors accordingly.[194] It provides that the profit derived from upstream petroleum operations is to be shared between the National Government and contractor in accordance with the petroleum agreement with the National's Government share of petroleum revenues before taxation being deposited into a dedicated petroleum fund and is to be exclusive of taxation.[195]

As regards to the transactions under the repealed Petroleum Act,[196] it provides for a transition in that anything done under its provisions is to be deemed to have been done under the provisions of the Petroleum Act, 2019.[197] The import of this provision is that the various statutory instruments granted then, including the various PSCs that have since transitioned into the current petroleum legislative framework.[198]Further, the Act provides for the preservation of contractual rights, privileges, liabilities and obligations that were existing pursuant to the repealed CAP 308.[199] In line with the aforementioned provision on preservation of contractual rights among other things, the drafters of the legislation were careful to maintain the various obligations and rights under the repealed law and as such it is similar to stabilization clause under the PSC.

Although the Petroleum Act 2019, incorporated a Model PSC, it is prudent to note that the 'new Model PSC' only applies to subsequent licenses that are issued under the Petroleum Act

[193] Preamble of Petroleum Act,2019 as read with Sec. 128(1) of Petroleum Act.
[194] Sec.3,*Petroleum Act*(No.2 of 2019).
[195] Sec. 58 Petroleum Act as read with Clause 39(3), Model Production Sharing Contract,2019.
[196] CAP 308
[197] Sec.128, *Petroleum Act*(No.2 of 2019).
[198] Sec.128(1)(b),*Petroleum Act*(No.2 of 2019).
[199] Sec. 128(2)(f),*Petroleum Act*(No.2 of 2019).

2019 and does not apply retrospectively.[200] The Model PSC[201] mandates the contractor to produce petroleum at a maximum efficient rate and forecasted quantities as estimated in the annual production programme while conserving the resource in line with best petroleum industry practice.[202] It also compels the contractor that prior to the commencement of production, the contractor to submit an annual production programme and budget for the next calendar year. [203]

As regards the cost recovery, the model PSC provides that the contractor is entitled to recover petroleum costs together with uplift at a capped rate of sixty percent (60%) from the contract area. The import of this is that cost recovery entitled to a contractor is capped at a certain percentage of the total production resulting from a contract area.[204]

Additionally, the model PSC provides for petroleum cost to be cost oil and cost gas. [205] For the purposes of cost recovery, the model PSC provides that the cost petroleum to be recovered in the following manner;

a) "*The petroleum costs, with the exception of development costs, incurred in respect of the contract area, shall be recoverable either in the fiscal year in which these costs are incurred or the fiscal year in which commercial production occurs, whichever is the later; and*

b) Development costs incurred in respect of each development area shall be recoverable in five (5) fiscal years at an annual rate of twenty percent (20%) by straight-line amortization at that rate starting either in the fiscal year in which such development costs are incurred or the fiscal year in which commercial production from that development area commences, whichever is the later."[206]

The development costs are defined as costs in respect of a development area incurred in respect of activities carried out in accordance with an approved development plan and the relevant annual development work programmes and budget consisting of costs before the commencement of commercial production in a development area and from the commencement of commercial production those costs which are capital in nature and relate to the continuous

[200] Sec. 128, *Petroleum Act*(No.2 of 2019).
[201] Model Production Sharing Contract,2019.
[202] Clause 33(1) Model Production Sharing Contract,2019.
[203] Clause 33(1)-(3) Model Production Sharing Contract,2019.
[204] Clause 36(1) Model Production Sharing Contract,2019.
[205] Clause 36(1) Model Production Sharing Contract,2019.
[206] Clause 36(2) Model Production Sharing Contract,2019.

development of commercial discovery and investment of recovery of petroleum.[207]Worth noting is that the development costs and production costs incurred in respect of a development area are not be recoverable until commercial production from that development area commences.[208]

Where the petroleum costs and uplift[209] exceed the value of cost oil or cost gas for a fiscal year, the excess cost shall be carried forward to the next fiscal year for purposes of cost recovery by the contractor in the subsequent fiscal year until fully recovered. [210]Where the petroleum costs and uplift recoverable in accordance with the above provisions is less than the maximum value cost petroleum, the excess of this shall be deemed as part of profit petroleum and divided accordingly.[211]

The Model PSC further provides for priority order of cost recovery petroleum and uplift and also provides for ring-fencing of such accordingly.[212] This prevents the contract from using the production from one resource area to offset costs of other production area.

As regards the profit petroleum, the Model PSC stipulates that the total petroleum produced and saved from the contract which is not used in the upstream petroleum operations or commercial production to which cost petroleum as discussed above has been removed. Such profit petroleum is to be shared and disposed of separately by the government and contractor on a quarterly basis in accordance with the R-factor in respect of the contract area formulated as [213]

Petroleum profit = Commercial Production – Cost Petroleum

R= X÷Y The R-Factor at a given date shall be calculated as follows:

whereby:

X is equal to the Contractor's Cumulative Cash Inflows at the end of

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[207] Clause 2.3 Appendix B-Accounting Procedure, Model Production Sharing Contract,2019.
[208] Clause 36(1) Model Production Sharing Contract,2019.
[209] Uplift refers to fifteen percent (15%) of development costs related to a development area and paid in a given fiscal year.
[210] Clause 36(1)(e) Model Production Sharing Contract,2019.
[211] Clause 36(1)(f) Model Production Sharing Contract,2019.
[212] Clause 36(2)(h), Model Production Sharing Contract,2019, provides for priority order as ;

I. Production Costs
II. Exploration Costs
III. Development Costs
IV. Uplift Costs
V. Decommissioning Costs

Clause 36(2)(j) provides that petroleum costs under the contract are not recoverable against other contract areas held by the contractor in Kenya.
[213] Clause 37(1) Model Production Sharing Contract,2019

the preceding Calendar Quarter

and

Y is equal to the Contractor's Cumulative Cash Outflows at the end

of the preceding Calendar Quarter

Or

Cumulative Cash inflows= cost petroleum + profit petroleum- production costs-decommissioning costs

Cumulative cash inflows= cost petroleum + profit petroleum-production costs-Decommissioning Costs

The Model PSC provides that the share of each category of profit petroleum entitled to each party in a calendar quarter in relation to R-factor is equal to the quantities of crude oil indicated as;[214]

R-Factor	**Government's share**	**Contractor's share**
Less than 1.0	**50%**	**50%**
Equal to or greater than 1.0 and less than 2.5	**65%**	**35%**
Equal to or greater than 2.5*	**(75)%**	**(25)%**

The contractor is obligated to calculate the R-factor for each quarter when the commercial production commences submitting the same to the Cabinet Secretary. Where the contractor is unable to calculate such in the relevant quarter prior to allocation of Profit petroleum, then the percentage for allocation such profit petroleum for the previous quarter shall be used. Where the allocation of profit petroleum in the previous quarter and the relevant quarter is the same, then no adjustment shall be made.

In the circumstance, the profit petroleum allocation differs between two quarters, the contractor is obligated to make adjustments to the Parties respective shares of profit petroleum as the case may be in order to restore them to the position they would have been in had the R-factor relevant to the Quarter had been available from the start of such Quarter.[215] Where an error occurs in such calculations resulting into changes in the percentage share of Profit petroleum,

[214] Model Production Sharing Contract,2019.
[215] Clause 37 Model Production Sharing Contract,2019.

the necessary corrections shall be made and adjusted accordingly where the benefiting party shall surrender the surplus to the disadvantaged party beginning the first day of Quarter following the Quarter in which the error was recognized.[216]

The importance of these quarterly adjustments speaks to the fluidity in the adjustment of profit ratio between the parties and the ability to provide a mechanism that adapts to the changes in the PSC as it correctly adjusts and captures the parties' share of profitability.[217]

Secondly, the adjustment is more financial oriented in that it factors the profit petroleum calculation rather than laying emphasis on the volumes produced.[218] The adjustments not only take into account how the R-factor is determined but it also takes into considerations where an error occurs in the calculation of the profit petroleum hence affecting the percentage share of party as it provides for mechanisms of correcting such accordingly.[219]

As regards the stabilization clause, the Model PSC provides that

> 'If *after the effective date of this contract the economic benefits of a party are substantially affected by the promulgation of new laws and regulations, or of any amendments to the applicable laws and regulations of Kenya, the parties shall agree to make the necessary adjustments to the relevant provisions of this contract, observing the principle of the mutual economic benefits of the parties.*'[220]

This clause is an economic equilibrium in nature in that where the Government of Kenya decides to enact a law that adversely impacts the IoC's then the IoC and GoK will agree on the necessary adjustments to the PSC as they observe mutual benefit. In essence it allows the parties to renegotiate the specific provisions of the contract in cases where the economic benefits of a party are substantially affected through the change in law, regulation or amendments.

3.3 Background to petroleum industry in Mozambique

Mozambique's oil and gas sector is guided by its Constitution and the various petroleum laws, regulations and the model exploration and production concession contract, discussed later in

[216] Clause 37(vii), Model Production Sharing Contract,2019.
[217] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development.*
[218] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development.*
[219] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development.*
[220] Clause 40(3) Production Sharing Contract between GoK and Turkana Drilling Consortium relating to Block 10BB as read with Clause 40(3) Production Sharing Contract between GoK and Platform Resources Inc. relating to Block 13T.

this chapter.[221] The repealed law earlier governing the industry were signed in the early 1980's[222] and with the Country discovering commercial viable deposits of gas in the Rovuma basin, it was generally believed that Mozambique had become resource rich and that terms of future exploitation of the resource should align with national interest.[223] As a result, in 2014, the country introduced two legislations that widely impacted its hydrocarbon sector and also developed a new Model EPCC.[224] Correspondingly, in the Kenyan context, this was around the same time in Kenya, post the promulgation of the Constitution of Kenya,[225]which espoused the Government's need in ensuring the sustainable exploitation of natural resources and their equitable sharing of accruing benefits that the Government began relooking at the executed PSC's with IoC's.[226]

In order to develop the sector further, the government introduced a taxation law[227] which was aimed at streamlining the sector and prescribing a production sharing framework between the Government and concessionaires which was widely expected to increase Mozambique's share of profitability in the recently discovered hydrocarbon reserves.[228]In the Kenya context, the Government of Kenya proceeded to enact a new petroleum law which was considered modernized in nature and fundamentally altered the how the profit petroleum between the Government and the IoC's would be shared thereby increasing its revenue from profit petroleum.[229]

3.4 Comparative study of the legal and contractual framework governing Mozambique's profit petroleum fiscal regime

Mozambique's petroleum fiscal regime is governed by Petroleum Law.[230]In the conduct of petroleum operations, the legal framework under which rights of the Government and concessionaire are governed is an exploration and production concession contract.[231]This is significantly different from Kenya's context which is governed by a Production Sharing

[221] De Barros J,' Mozambique' in Eduardo Pereira and Kim Talus(eds) *Upstream law and Regulations; A global guide,* Globe business publishing limited, london,(2017),105.
[222] Petroleum Activity Law of 1981.
[223] Da Cunha Diogo Xavier, 'Mozambique getting ready to negotiate new upstream concessions,'(2016).
[224] Petroleum Law(Law No.21 of 2014 & Petroleum Tax Law (Law No.27 of 2014).
[225] 2010
[226] Hubert D, 'Potential Petroleum Revenues for the Government of Kenya: Implications of the proposed 2015 Model Production Sharing Contract,' *Oxfam,* 2016.
[227] Hydrocarbon Tax Law No.27 of 2014
[228] Inglis J and Mandelli J L, 'Mozambique's new petroleum legislation completed: Toeing the line in a challenging market.*'Energy Update* Vol 2,(2016).
[229] Under the new Petroleum Act 2019, it adopted the R-factor fiscal regime as a basis of sharing profit petroleum between the Government and the IoC's.
[230] *Petroleum Law*(No.21of 2014).
[231] Article 30, *Petroleum Law*(No.21of 2014).

Contract as regards the nature of the HGI. The key difference regarding the petroleum sharing between the HG and the IoC under the two contractual framework is the Concession's adoption of royalty payable to the HG.[232] This is seen in Mozambique's signed concession contract under the Petroleum Production Tax of ten percent (10%) on all petroleum produced.[233]This is a fundamental difference in Kenya's PSC and Mozambique's EPCC.

The tax law of Mozambique provides that the concessionaire will recover their cost incurred from petroleum operations through quantity of petroleum produced and available at the delivery point.[234]This is a similarity in the Kenyan context where the Model PSC,2019 provides for cost recovery to the IoC through petroleum produced.[235]

As regards existing concession contracts, the law provides that such concession acquired under the repealed law are still valid, however upon their termination, new contracts and concessions will be executed under the terms of present law.[236]In the Kenyan context, this provision is buttressed under the Petroleum Act,2019 which continue to breathe life into existing PSC's life.[237] Regarding Mozambique, the import of this is that most of the concession contracts signed prior to the changes in legislation in 2014 continue to subsist under the previous legislative regime they were signed in.

In 2014, after the promulgation of the new petroleum laws as highlighted above and the development of a new Model EPCC which was used for the 5th Licensing rounds resulting into signing of five(5) new EPCC contracts embedding a new R-factor fiscal regime.[238]Prior to the enactment of these legislations, most concessions awarded were negotiable on cost recovery limit and the profit petroleum share between them and the Government.[239]In the Kenya context, Kenya has not yet signed any new PSC under the R-factor fiscal regime despite changing its petroleum laws and adopting a new Model PSC,2019 as highlighted above.

Under one of the executed exploration and production concession contracts (EPCC) in accordance under the current petroleum legislation,[240]the cost recovery allowable to the

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[232] Johnston D, *International Petroleum Fiscal Systems and Production Sharing Contracts.*
[233] Article 11.6 Exploration and Production Concession Contract between Government of the Republic of Mozambique and Exxon Mobil, RN Zambezi as at 2018(EPCC).
[234] Article 31, *Petroleum Law* (No.27 of 2014).
[235] Clause 36(1), Model Production Sharing Contract, 2019.
[236] Article 68 *Petroleum Law* (No.27 of 2014).
[237] Sec.128,*Petroleum Act*(No.2 of 2019).
[238] Da Cunha Diogo Xavier, 'Mozambique getting ready to negotiate new upstream concessions,'(2016),14.
[239] Da Cunha Diogo Xavier, 'Mozambique getting ready to negotiate new upstream concessions,'(2016),9.
[240]Exploration and Production Concession Contract between Government of the Republic of Mozambique and Exxon Mobil, RN Zambezi as at 2018(Exploration and Production Concession Contract).

concessionaire is capped at sixty percent (60%) of the cost petroleum.[241] In the recovery of costs, the contract provides that cost petroleum shall be constituted of;[242]

a) Exploration cost
b) Development and Production capital expenditures
c) Operating costs
d) Service costs
e) Decommissioning costs

However, it is noteworthy that Mozambique's limited capacity in auditing and approving cost recoverable has cost them significant revenue to a tune of thirty-three million dollars between 2015-17.[243]

In the Kenyan context, the Model PSC 2019 provides cost recovery cap of sixty percent (60%) of cost petroleum and further proceeds to provide cost recovery to be recovered in the following order;[244]

a) Exploration costs
b) Development costs
c) Production costs
d) Uplift
e) Decommissioning costs

The law provides that the profit-petroleum shall be shared between the State and concessionaire in accordance with a variable scale depending on the value of R-factor, where;[245]

a) R factor $\frac{\text{(Accumulated cash receipts)}}{\text{(Accumulated Investment expenses)}}$

The Petroleum Law as read with the EPCC further provides that the profit petroleum between the Government and concessionaire will be shared in accordance with R-factor and it shall be in the following scale;[246]

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[241] Article 9 Exploration and Production Concession Contract as read with Article 31 of *Petroleum Law* (No.27 of 2014).
[242] Annex C of the Exploration and Production Concession Contract.
[243] Publish what you pay, *Fair share?shinning a light on the extractive industries fiscal regimes in Mozambique,Tanzania and Uganda*,2021.
[244] Clause 36(1) Model Production Sharing Contract,2019 as read with Clause 2.1. of. The Accounting Procedure.
[245] Article 32(4),*Petroleum Law* (Act No.27 of 2014).
[246] Article 32(7) of Law No. 27 of 2014 as read with Article 9.7 of the Exploration and Production Concession Contract.

R-factor	Government's portion	Concessionaires Portion
Less than 1	15%	85%
Equal to or greater than 1 and less than 1.5	25%	75%
Equal to or greater than 1.5 and less than 2.0	35%	65%
Equal to or greater than 2 and less than 2.5	50%	50%
Equal to or greater than 2.5	60%	40%

Worthy to note, prior to the enactment of the 2014 petroleum laws in Mozambique, the division of profits percentages was negotiable elements of the EPCC.[247] However, with the enactment of Petroleum Tax Law, the Government's share of profitability was entrenched above.[248]

In addition to this, it has since then been observed that when the Government of Mozambique made changes to its taxation laws especially the capital gains tax, there was early income due to the Government from the concessions prior to the production stages.[249]

In the Kenyan Model PSC, 2019, it provides that the sharing of profit petroleum between the Government and the IoC will be based on an R-factor fiscal regime provided as $R= X\div Y$

whereby;
X is equal to the Contractor's Cumulative Cash Inflows at the end of
the preceding Calendar Quarter
and
Y is equal to the Contractor's Cumulative Cash Outflows at the end
of the preceding Calendar Quarter.[250]

[247] Da Cunha Diogo Xavier, 'Mozambique getting ready to negotiate new upstream concessions.'
[248] Article, 32 Petroleum Tax Law No.27 of 2014.
[249] Centre for Public Integrity, 'Taxing Capital Gains in Mozambique's Extractive Sector,'12th Edn,(2014).
[250] Clause 37, Model Production Sharing Contract,2019.

In addition to this, Kenya's R-factor scale for sharing of profit petroleum is provided as;[251]

R-Factor	Government's share	Contractor's share
Less than 1.0	**50%**	**50%**
Equal to or greater than 1.0 and less than 2.5	**65%**	**35%**
Equal to or greater than 2.5*	**(75)%**	**(25)%**

A comparison of the above sharing scale on R-factor by the two Countries, puts Kenya's profit petroleum share at a higher bandwidth as compared to Mozambique's. Additionally, by making the bandwidth to be only a three tier system ;(i)Less than 1.0 (ii)Equal to or greater than 1.0 and less than 2.5 and (iii) Equal to or greater than 2.5* is more beneficial to the Government in the sense that the Government's share of profit petroleum are high and well defined.[252]This essentially means that with the enactment of the Model PSC 2019, Kenya stands to benefit more on the profit petroleum split it receives from the IoC's.

Regarding the stabilization clause, Mozambique's clause provides that

> "*In the event of a change in legislation affecting Petroleum Operations that cause a material adverse impact to the expected economic benefit of the concessionaires or of the Government under this EPCC, the parties shall following the enactment of such change in legislation, meet to verify and seek agreement on adjustments required to restore the economic benefit the concessionaires or the government would have derived if such change in legislation had not occurred.*"[253]

Additionally, the Petroleum Tax law provides for a tax stabilization for a period of ten-years which can be negotiated to begin on the date of the approval of the development plan which is ten(10) years.[254] In addition to this, the fiscal stability can be extended from the 11th year through the payment of additional two percent (2%) of the Production tax. [255]The import of this clause is that it is a NEB clause in nature where parties can sit re-negotiate the terms of its concessions.[256] The Government of Mozambique has further tightened this provision with

[251] Model Production Sharing Contract, 2019.
[252] Hubert D, 'Potential Petroleum Revenues for the Government of Kenya.
[253] Article 134 Exploration and Production Concession Contract.
[254] Article 43,*Petroleum Tax Law* (No.47 of 2014).
[255] Centre for Public Integrity, '*Beyond Rovuma Natural Gas Understanding the Implications of the 2014 Laws*,'12th edn,(2014).
[256] Centre for Public Integrity, 'Taxing Capital Gains in Mozambique's Extractive Sector.'

stabilization period being only ten (years) or where the concessionaire elects for an extension, pays the additional two percent (2%) Production tax.

In the Kenyan context, the Model PSC,2019 on stabilization provides that

'If *after the effective date of this contract the economic benefits of a party are substantially affected by the promulgation of new laws and regulations, or of any amendments to the applicable laws and regulations of Kenya, the parties shall agree to make the necessary adjustments to the relevant provisions of this contract, observing the principle of the mutual economic benefits of the parties.*'[257]

In comparison to Mozambique's, the stabilization clause is similar in the sense that both of them are NEB in nature.[258] As discussed above in chapter 2, a NEB clause mandates parties to meet and negotiate on the terms of the change. As a result, Mozambique is in the process of relooking at its earlier concessions with IoC's in order to ensure compliance with Petroleum Laws of 2014.[259]The major departure in comparison between the Kenyan and Mozambique's stabilization clause is the Mozambique's provides a fiscal stability of ten (10) years and where such a period lapses and no re-negotiation happens, then an additional two percent (2%) of production tax is implemented.

3.5 Conclusion

In summary, the differences and similarity of Kenya's and Mozambique's profit petroleum fiscal regime can be tabulated as;

Differences		
	Kenya	**Mozambique**
Contractual relationship	Adopted a Production Sharing Contract.	Adopted a Concession Contract.
Entitlement	Profit Oil	Royalty payment on all petroleum produced at 10%.

[257] Clause 52(3) Model Production Sharing Contract, 2019.
[258] Maniruzzman AFM, 'The pursuit of stability in international energy investment contracts.
[259] Da Cunha Diogo Xavier, 'Mozambique getting ready to negotiate new upstream concessions,'(2016).

Model Contract	Kenya is yet to negotiate a PSC under its new Model PSC, 2019.	Negotiated new EPCC under its 2014 Model PSC under the 5th licensing round.
Cost Petroleum due to IoC	a) Exploration costs b) Development costs c) Production costs d) Uplift e) Decommissioning costs	a) Exploration cost b) Development and Production capital expenditures c) Operating costs d) Service costs e) Decommissioning costs
R-factor Bandwidth on profit petroleum.	The PSC entrenches a three-tier bandwidth of higher ratios to be shared on the profit petroleum.	The EPCC adopts a four-tier bandwidth of lower ratios to be shared on the profit petroleum.
Tax stabilization	None	Provides a 10-year stability and from the 11th year an additional payment of two percent (2%) of the Production tax.
Similarities		
Cost recovery	Cost to be recovered by contractor through petroleum produced. Capped at 60%	concessionaire recovers their cost incurred from petroleum operations through quantity of petroleum produced. Capped at 60%

Transition of pre-existing contracts under repealed provisions of law.	All PSC's signed under repealed law continue to subsist and remain valid	All Concession Contracts signed under repealed law subsist and remain valid.
Stabilization Clause	If there is any promulgation of new laws and regulations, or of any amendments to the applicable laws and regulations that substantially affects a party, then the parties are mandated to meet and agree to make the necessary adjustments to the relevant provisions of the PSC while observing the principle of the mutual economic benefits of the parties.	In the event of a change in legislation affecting petroleum operations that cause a material adverse impact to the expected economic benefit of the concessionaire, then parties are obligated to meet, verify and seek agreement on adjustments required to restore the economic benefit.

It has been noted that with Mozambique's entrenchment of the R-factor production sharing in its EPCC's and the non-negotiability of the terms of the R-factor has immensely increased additional profit petroleum that is due to the Government.[260] In addition to this, Mozambique has entrenched a robust and effective fiscal regime that enables it benefit from the concessions entered into.[261]From the above comparison, it can be therefore be concluded that indeed Kenya's R-factor profit petroleum fiscal regime is competitive and would be beneficial to the Government of Kenya in terms of additional profit petroleum accrued to it upon production.

[260] Centre for Public Integrity, 'Beyond Rovuma Natural Gas Understanding the Implications of the 2014 Laws.'
[261] Publish what you pay, *Fair share?shinning a light on the extractive industries fiscal regimes in Mozambique,Tanzania and Uganda*.

Chapter Four: ANALYSIS OF DROP & R-FACTOR FISCAL REGIME AND THE RESULTING CONTRACTUAL IMPLICATION OF THE CHANGE.

4.1 Introduction

This chapter analyses the DROP and R-factor fiscal regime by highlighting the shortcomings of DROP regime and how the R-factor regime has come in to cure some of those shortfalls. It further proceeds to discuss the key contractual issues and barriers that need to be overcome in order to change the fiscal regime from DROP to R-factor regime. Additionally, it draws key lessons that Kenya can borrow from Mozambique's implementation of their R-factor fiscal regime.

4.2 Analysis of DROP & R-factor fiscal regime

4.2.1 DROP Fiscal Regime Analysis

The PSC's provided under the repealed law are based on the DROP fiscal regime which provides for a more generous fiscal terms to the contractor as compared to other fiscal regimes on the basis of post-tax contractor rates of return.[262] In as much as the DROP fiscal regime mandates the contractor to produce petroleum at a maximum efficient rate in accordance with international industry practice, it does not provide specific measures to ensure such efficient rates are achieved albeit only through the annual production programme.[263] For example, where the international market prices of crude oil are on an all-time low and the IoC is incurring a higher operating cost for production, most IoC's will scale down operations resulting into less production of crude since the market conditions are unfavorable.[264]

Under such circumstance and in light of the Kenya's context, there is no available remedy to GoK under the PSC to compel the IoC to scale up production. This is further exacerbated in a situation where the market prices are on all time high but the IoC has run into financial headwind and is unable to scale up their operations to produce more barrels of oil. The existence of such a gap would not make the DROP fiscal regime an equitable sharing regime in light of the low volume of production against a backdrop of high profitability market conditions.

[262] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*, 202.
[263] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*, 202.
[264] Anderson L *et al*, *International Petroleum Law and Transactions.*

Secondly, the repealed Model PSC does not provide for a definite cost recovery cap percentage instead leaving it open ended to be negotiated between the parties. This has a consequential effect on the profit petroleum share between the IoC and GoK since the percentage for cost oil that is open can be negotiated even to a higher percentage depending on the negotiating prowess of the IoC.[265]

The other challenge as regards the DROP fiscal regime is that the profit petroleum shared between the IoC and GoK is pegged on the oil produced per day, implying that in order to meet the volumes as described in the tranches for purposes of sharing the profit petroleum, then the IoC will have to produce more barrels of oil as its gross production. The import of this is that where the IoC is meant to share the first 20,000 barrels of oil, then the gross production per day shall be in the range of 100,000 barrels in order to cover for its cost oil.

Accordingly, this has a further ripple effect on the subsequent tranches and this is further implied as the volumes of profit petroleum increases as per the table to the next 30,000 barrels and so on. The key challenge to attaining such high levels of gross production is the reservoir geology and the necessary volumes of crude termed as recoverable. For example, Tullow oil Kenya 'estimates' that the resource in South Lokichar basin is 560,000,000 mmbo of which 240,000,000 mmbo are recoverable.[266]

However, the same is classified as a class 1C resource denoting that its undeveloped since it's a contingent resource of sub-commercial value to which lesser volumes may be actually recovered depending on the method of production.[267] This is further compounded by Tullow's current production plan of 60,000 to 80,000 barrels of oil per day under the first phase of production in their field development plan[268], and secondly, the IoC's continuous shift in goal posts as regards the Final Investment Decision in the Kenyan venture.[269]

4.2.2 R-Factor Fiscal Regime Analysis

On the other hand, the introduction of R-factor through the Petroleum Act 2019 has espoused the issue of production by mandating the IoC to produce petroleum at a maximum efficient rate

[265] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[266] https://www.tullowoil.com/our-operations/africa/kenya/ on 2 February 2021.
[267] https://www.tullowoil.com/our-operations/africa/kenya/ on 2 February 2021.
[268] https://www.tullowoil.com/our-operations/africa/kenya/ on 2 February 2021.
[269] https://www.businessdailyafrica.com/bd/news/tullow-changes-kenya-s-oil-exports-date-to-2024-2261792 and https://www.standardmedia.co.ke/business/article/2001360845/tullow-oil-the-big-lie on 2 February 2021.

and forecasted quantities as per the annual production programme while conserving the resource in line with the best industry practice.[270]

Worthy to note that this is a clear expression of mandate as compared to Mozambique's context in the sense that Mozambique's EPCC does not mandate the concessionaire to produce at maximum efficient rates. Further as regards to Kenya, the Petroleum Act has empowered the Cabinet Secretary to approve the contractor's annual work programme and production forecasts upon recommendation of the EPRA implying that the HG has a say in the annual work programme and production forecasts.[271]

This is similar to Mozambique's ECCP albeit better in the sense that in the Kenya context, EPRA is mandated to make recommendations to the annual work programme while the Institute of National Petroleum of Mozambique (INP) is only mandated to approve the same.[272]

As a way of improving from the deficits of the repealed Model PSC which did not elaborately provide for all the relevant costs due to the IoC, the current Model PSC 2019 proceeded to factor in all the relevant costs and highlighted the same as recoverable to the IoC. [273]The costs are petroleum costs and development costs.

The express specification regarding when such costs are to be recovered is important due the direction that such costs are only recoverable within the year they are incurred or upon commercial discovery. This enables the GoK track all the costs and when they occurred for determination of their recoverability by the IoC. [274]

In addition to this, the Model PSC provides for the priority order of costs as enumerated in its clause 36(2)(h), which in essence provides for an ease of identification of costs and the pecking order of the same. This is the same position in Mozambique's context where the executed EPCC provides for a similar process.[275] Further, the Model PSC is linked to an easier implementation as it eliminates the need to account for oil and gas separately providing a flexibility and much needed progressiveness as it factors lower rates of taxation for marginal projects regardless of volumes produced.[276]

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[270] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[271] Section 10(e), *Petroleum Act* (Act No.2 of 2019).
[272] Article 3.6 Exploration and Production Concession Contract.
[273] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[274] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[275] Article 9 Exploration and Production Concession Contract.
[276] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.

As a result of this deemed flexibility, the R-factor is considered to provide durability to fiscal regimes with no changes whether the venture is profitable or not hence giving the much-needed stability a Country's petroleum fiscal regime needs in order to attract investors.[277] In addition to the simplicity in implementation of the R-factor, it is given due consideration in light of the divergent expectations between the HG and IoC on the basis that it is less sensitive to cashflows timings and gold plating[278] of costs arising from project timelines.

4.2.3 **Comparison between DROP and R-factor fiscal regime**

R-factor as compared to DROP is regarded as comprehensive and does not require additional fiscal instruments in order to capture most of the elements that were not factored in it.[279] What is simply needed is a cost recovery cap on the petroleum used for such purposes and the same has been incorporated in the Act[280] at sixty percent (60%).[281]

In the same line, in order to tighten the noose on the issue of cost recovery by the IoC, the introduction of ring fencing of costs under the Model PSC was long overdue. Ring fencing of costs has been enumerated to cover block ring fencing in that the petroleum costs incurred by a contractor are not recoverable against other contract areas held by the same contractor in Kenya.[282]This is also espoused in Mozambique's EPCC where ringfencing costs is on the production sharing.[283]Mozambique has also adopted a similar strict approach to ringfencing. From the above EPCC, the concessionaire's report their annual profits per area of the concession contract.[284]

The introduction of cost uplift under the Model PSC 2019 is another important milestone in changing the petroleum fiscal regime of Kenya and the resultant incentive investment for the IoC.[285] Cost uplift under the new Model PSC changes the incentive landscape to the IoC by replacing the cost recoverability of interest on borrowing as provided by the repealed Model PSC.[286] Previously, the repealed Model PSC provided that an investment incentive on interest

[277] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*, 202.
[278] Gold plating refers to where a company benefits by spending additional costs than it would have done under ordinary circumstances.
[279] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[280] Petroleum Act No.2 of 2019.
[281] Clause 36(1) Model Production Sharing Contract, 2019 as read with Beardsworth, St and Husbands *Kenya Oil and Gas Sector Development*.
[282] Clause 36(2)(j) Model Production Sharing Contract 2019.
[283] Article 9 Exploration and Production Concession Contract.
[284] https://www.vda.pt/xms/files/v1/Newsletters/en/2016/Flash_VdAtlas_Mozambique_-_Regulations_of_the_Petroleum_Taxation_Law_-19_01_2016-.pdf on 7th October 2021.
[285] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[286] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.

incurred on loans raised by the contractor for capital expenditure in petroleum operations under the contract at a rate not exceeding prevailing commercial rates are recoverable as petroleum costs.[287]The import of this was that IoC's could obtain commercial loans so as to invest in the oil and gas sector, and these loans serving as their capital expenditure would be borrowed on commercial terms earning market rate interest. Such market rate interest incurred by the Contractor, would be recovered by them through terming them as petroleum costs.

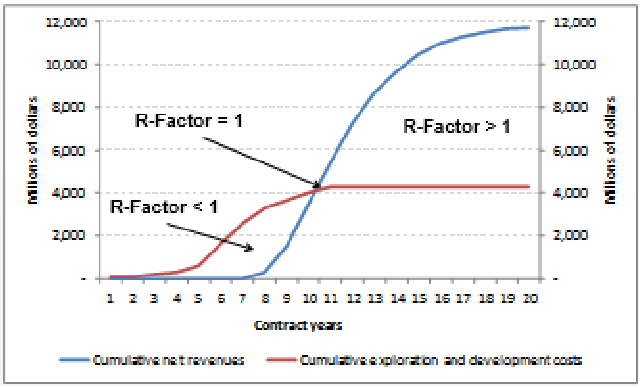
However, such loans are susceptible to manipulation by IoC's for purposes of cost recovery especially where an IoC being an affiliate of a foreign company, would borrow such capital investment from the parent company and proceed to term it as 'commercial loan' in the guise maximizing on cost recovery. In order to cure this potential defect by the investment incentive, cost uplift was introduced to encourage investment by allowing the IoC recover an additional percentage of its cost oil. It was however capped at fifteen percent (15%) of the development cost reducing the potential of the IoC to manipulate their recoverable cost petroleum.[288]

In addition to this, R -factor does not require windfall profit tax as any significant 'windfall' increase in the market price of crude oil will automatically flow through the HG bands of production sharing within it.[289] As regards to DROP, windfall tax is a key component as it is not fully responsive to changes in market price hence windfall tax has to be incorporated in order to capture any additional profits as a result of market price changes.[290]

Further, it is opined that the use of R-factor in the share of profitability of the hydrocarbon results into a closer correlation on the division of the profits between the IoC and the HG as compared to other formulas.[291]

[287] Appendix B,2.12.2 repealed Model Production Sharing Contract.
[288]Hubert D, 'Potential Petroleum Revenues for the Government of Kenya.'
[289] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[290] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[291] Land B, 'Capturing a fair share of fiscal benefits in the extractive industry,'166.

The graph below is an illustration of the calculation of R-factor.



Source: Joint Steering Committee on Proposed Gas Terms.

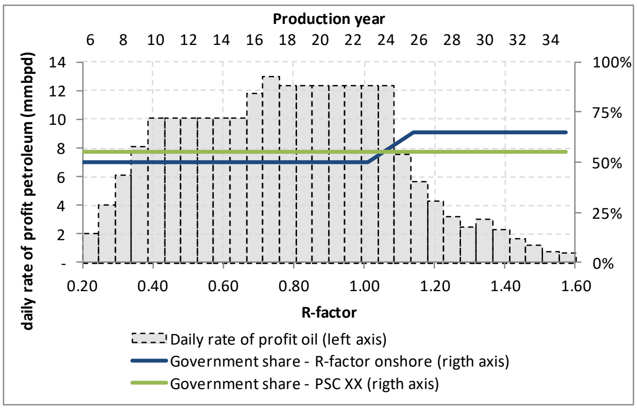
The blue line graph shows the cumulative IoC net revenues while the red line graph is the cumulative exploration and development costs for an illustrative project. The R-factor is the ratio between these two amounts.

From the above graphical illustration, the point at which these two lines crosses is exactly where the R-factor is equal to 1. Simply put, the revenue generated from the project is equal to the costs incurred in the exploration and development phase of the project. When the blue line is below the red line, the R-factor is less than 1 implying that costs incurred in the project has outnumber the revenue generated hence the project made a loss. Where the blue line is above the red line, it depicts that the R-factor is greater than 1 implying that the project revenue generated is more than the exploration and development costs incurred hence the venture is profitable. Where the venture is profitable, the R-factor by design allocates a higher proportion of profit to the government.

In order to contextualize the above, the Model PSC provides that where the r-factor is less than 1.0, then the government share and the contractor share is at 50% each. Essentially, the parties receive the same amount of profit share. Where the R-factor is equal to or greater than 1.0 and less than 2.5, then the government share increases to sixty-five percent (65%) while the contractor take is thirty-five percent (35%). Where the R-factor is equal to or greater than 2.5, then the government share is seventy-five (75%) while the contractor take is twenty-five (25%) percent.[292] This has provided the GoK with a higher profit petroleum sharing mechanism as compared to the DROP regime.

[292] Clause 37, Model Production Sharing Contract 2019.

Additional analysis of government share of profit petroleum using both the DROP and R-factor is graphically depicted below[293]



Source: IMF, Kenya's technical notes on extractives

The above graph illustrates how the share of government changes bi-annually under the two fiscal regimes. Under the DROP regime, in as much as the volumes depicted increase over the production life of the project, it is worth noting that the government share only increases to a certain limited threshold and does not surpass that threshold in as much as the volumes of profit petroleum increases over that similar period of time.[294] Hence, it is noted that DROP fiscal regime does not respond directly to profitability of the investment.[295] Therefore, upon reaching peak production, GoK's share of profit petroleum remains constant at best despite the increase in profitability of the project.

As regards the R factor, the share of government's profit petroleum remains constant through the production years and does not fluctuate as in DROPs case. The Government's share remains constant during the initial production years at a peak percentage and eventually increases over the life of the project until peak production since it responds to the various elements or changes that affect the R-factor regime.[296]

Worthy to note that at year twenty-one of the production year, once the R-factor is equal to one, implying that costs have matched the revenue, then the share of government profit gradually increases over the life of the project indicating that the value of R-factor increases as the project progress over the production years. Subsequently, as production falls, the share of

[293] Daniel P, Puyo DM, Leuch H, *Technical notes on Extractive Industries Fiscal Regimes*,21.
[294] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[295] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[296] Daniel P *et al*, *Technical notes on Extractive Industries Fiscal Regimes*.

government still remains at an all-time high indicating that it maximizes its share of profitability throughout the gestation period of the investment.[297]

The above analysis has taken into consideration the HG's profit petroleum share under the existing PSC.

The other additional benefit of the change in fiscal regime that significantly departs from the repealed model is the introduction of tax-free portion of government's share of profit petroleum. The Model PSC provides that the share of profit petroleum due to the government shall be exclusive of all taxes payable to the contractor.[298]

In the repealed Model PSC, the GoK was mandated to pay from its share of profit petroleum on behalf of the Contractor all taxes present or future based on income or profits. [299] The payment by government of such taxes had significant impact on its legitimate share of profit petroleum obtained from the venture and the shift provided for in the new regime to the contractor paying its own tax obligations adds additional revenue to the GoK.[300]

As enumerated above, the introduction of R-factor fiscal regime has numerous benefits to the GoK through it having a say in the annual work programme and production forecast by approving it, hence the contractor cannot just populate an annual programme and submit the same to the government.[301] Secondly, the R-factor has considered all the necessary cost and given the priority order of recovering them in addition to capping the same at sixty percent. This is an important step in consolidating the costs that an IoC can recoup and also providing certainty as to the Contractors cost. In the same vein, the introduction of ringfencing of costs is another important step in helping GoK in ascertaining the IoC's costs regarding each PSC.

The introduction of the costs uplift as regards incentivizing the IoC while having a line sight on the cost oil is also important in GoK safeguarding its share of profit petroleum.[302]

The unilateral action by GoK in changing its fiscal regime under the new legislation in its petroleum sector is on the premise of capturing a fairer share of the fiscal benefits with a likely impact on the sector.[303]Such an action by a HG triggers the IoC's with already sunk costs to respond on the basis of their financial and strategic interests. Where the investment is lucrative,

[297] Daniel P *et al*, *Technical notes on Extractive Industries Fiscal Regimes.*
[298] Clause 39(3) Model Production Sharing Contract.
[299] Clause 27(5) repealed Model Production Sharing Contract.
[300] Hubert D, 'Potential Petroleum Revenues for the Government of Kenya,'4.
[301] Section 10(e),*Petroleum Act* (Act No.2 of 2019).
[302] Beardsworth and Husbands, *Kenya Oil and Gas Sector Development*.
[303] Land B, 'Capturing a fair share of fiscal benefits in the extractive industry,'159.

the IoC will prior to accepting such changes seek a renegotiation of the terms earlier agreed upon in order to be reflective of the changes. In order to renegotiate the terms of a PSC in particular the fiscal terms, the stabilization clause in the PSC ought to be interpreted in a manner that is as intended by the parties.

4.3 Contractual Implication of the change from DROP to R-factor fiscal regime

4.3.1 Stabilization Clause and its contractual interpretation

As noted in chapter two above, Kenya's stabilization clause in its nature is a NEB and requires a proper legal interpretation since more often than not interpretation is varied in order to suit a party depending on which side of the negotiating table one sits on. However, for the parties to make the necessary adjustments on the premise of the stabilization clause, a correct legal interpretation that can make sense of it is of great importance.

Due to the broad wording of the stabilization clause in Kenya's context a narrow interpretation of such an important clause can prove to be fatal to both parties given the ever-changing circumstance whether domestically as regards the legislative process and court interpretation or in the international arena of hydrocarbon operations such as pricing and market demand. In interpreting the stabilization clause and the PSC as a whole, the parties and to a last resort, the arbiter will interpret the contract in a manner that befits the intention of the parties.[304] In doing so, the golden rule of interpretation will be used to interpret terms to the PSC in order to ascertain their intentions [305]and the courts have explained the golden rule of interpretation as;[306]

> "*……. interpretation, the language in the document is to be given it's grammatical and ordinary meaning, unless this would result in some absurdity or some repugnancy or inconsistency with the rest of the instrument… The mode of construction should never be to interpret the particular word or phrase in isolation (in vacuo) by itself. The correct approach to the application of the 'golden rule' of interpretation after having ascertained the literal meaning of the word or phrase in question, is broadly speaking, to have regard;*

[304] Lord Neuberger in *Marley v Rawlings* (2014) 2 WLR 205.

[305] *Engelbrecht v Senwes(2007) 3SA 29 SCA.* The learned judge held that '…The intentions of the parties is ascertained from the language used in its contextual setting and in light of admissible evidence. There are three classes of admissible evidence. Evidence of background fact is always admissible. Those facts, maters probably present in the minds of the parties when they contracted, are part of the context and explain the 'genesis of the transaction' or its factual matrix. Its aim is to put court in the arm chair of the authors of the document. Evidence of surrounding circumstances is admissible only if a contextual interpretation fails to clear up any ambiguity or uncertainty. Evidence of what passed between the parties during negotiations that preceded the conclusion of the contract is admissible only in the case where evidence of the surrounding does not provide sufficient certainty.'

[306] *Coopers & Lybrand v Bryant* 1995(3) SA 761.

a) *To the context within which the word or phrase is used with its interrelation to the contract as a whole, including the nature and purpose of the contract.*
b) *To the background circumstances which explains the genesis and purpose of the contract as well as matters present to the minds of the parties when they contracted.*
c) *To apply extrinsic evidence regarding the surrounding circumstances when the language of the document is on the face ambiguous, by considering previous negotiations and correspondence between the parties, subsequent conduct of the parties showing the send in which they acted on the document, save, direct evidence of their own."*

In order to contextualize the above, Kenya's PSC as aforementioned, requires that where upon the effective date of the PSC, the economic benefits of a party are substantially affected by the promulgation of new laws and regulations or of any amendments to the applicable laws and regulations of Kenya, then the parties shall agree to make the necessary adjustments to the relevant provisions of the PSC while they observe the principle of mutual economic benefits of the parties.[307]

From the foregoing, the stabilization clause mandates the parties to agree to make the necessary adjustments to the PSC which leads to the issue of the process on how the contracting parties are to agree on making the necessary adjustments relevant to the provisions of the PSC while observing the principle of economic benefit of the parties.

Where an interpretation of a stabilization clause is not interpreted as above, it provides the HG with a leeway to undermine its purpose as it is perceived to grant stabilization with one hand and subsequently take it with the other hand in circumstances where the clause is narrowly interpreted or does not favor their national interest. In such circumstance, tribunals have also pointed out that the narrow interpretation of laws in order to benefit HG is not acceptable before them.[308]Hence stabilization clauses, ought to be carefully worded so that the legislative action triggers a definite renegotiation.

[307] Clause 40(3) Production Sharing Contract between GoK and Turkana Drilling Consortium relating to Block 10BB as read with Clause 40(3) Production Sharing Contract between GoK and Platform Resources Inc. relating to Block 13T.
[308] In *Yury Bogdanov v Republic of Moldova Arbitration No V(114/2009)*, the arbiter in the matter opined that..' it is further not reasonable to construe the stabilization clauses in Law 625/1195 and Law 440/2001 so narrowly that they would leave it open to the Republic of Moldova to change the customs regime at will as long as so was done by legislation other than these two particular laws. To so construe the clauses would make them void of any real meaning.'

Stabilization as a concept elicits different reactions depending on which side of the negotiating table one sits on. To the investor, they foresee stability of contracts in order to meet the financier's obligations and to maximize their profit-making venture.[309] To a HG, the key focus is control over natural resources and maximizing the economic rent.[310]

HG's especially the developing and the least developing ones have adopted a trend of invoking sovereign prerogative in order to modify or amend the contractual engagements due to perceived imbalance and exploitation of those contracts. In contrast, the IoC has limited countermeasure recourse to such actions.[311] In Mozambique's context, the Government is yet to re-engage the concessionaires in a bid to re-negotiate EPCC's signed in the earlier licensing rounds prior to the enactment of the petroleum laws in 2014 so as to comply with the changes.

4.3.2 **Contractual principle of *pact sunt servanda***

The IoC will always invoke the principle of *pact sunt servanda* that parties ought to maintain and respect the terms of the agreement they had bargained for in the contract since parties had both capacity and free will to negotiate the PSC.[312]The essence of such a principle is to provide certainty and predictability in investments that span over long periods of time. If contracts were uncertain, unpredictable and non-binding on parties, a party would arbitrarily alter the terms of the agreement, and the investments jeopardized.

However, as noted above, the changes in circumstance in the oil and gas sector especially as regards to subsurface risks such as market price changes and global demand in crude oil tends to make the HGI more susceptible to change in order to reflect the changes in surrounding environment, be it pricing, demand for crude oil, political volatility or perceived revenue share. Where parties fail to consider such changes in their HGI, then the likelihood of a HG invoking an unforeseen and extra ordinary circumstance under the *force majeure* clause in the PSC in order to deem it inoperable is quite high.

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309 The HG- IoC conversation over revision of existing contracts dates back post colonization period where newly independent Countries sought to recondition existing international regimes that would reflect changes in their social and economic needs. This led to the introduction of permanent sovereignty over natural resources principle to which was embodied in the United Nations General Assembly.

310 The amount of money earned that exceeds that which is economically or socially necessary.

311 'Resource Nationalism in Africa - Wish You Were Mine | Middle East & Africa | The Economist' <https://www.economist.com/middle-east-and-africa/2012/02/11/wish-you-were-mine> accessed 27 January 2021.

312 Botchway N F, 'Can the law compel business parties to negotiate?, *'Journal of World Energy Law and Business*,(2010), 291.

Typically, a PSC is a long-term contract that spans over twenty years due to the amount of work involved in it, from exploration to well appraisals to production. Contractual commitments made over such duration of time are most definitely prone to be affected by factors/events not foreseen by the parties at the commencement of the contract.

Where the HG makes changes either in legislation or taxation, as is the case with Kenya and Mozambique, which directly impacts on the investment by the IoC in a negative manner. The IoC has contractual remedies which are limited to damages, and may be indemnification, depending on the wording of the contractual clause. In the Kenyan case, this can be found in the stabilization clause of the PSC's which mandates the parties to agree to make the necessary adjustments to the relevant provisions of the PSC, as they observe the principle of mutual economic benefits of the parties. [313]

Generally, most IoC's will not on a first instance pursue the option of damages and indemnification, highlighted above, in light of the capital investment made, the prospects of the venture and the desire to retain a '*good working relationship*' with the HG.[314] They will often abide with the stabilization clause and in the case of Kenya, seek the return on the investment to a closer position as they were in before such changes occurred. This often leads to renegotiation of the terms of the PSC's as they observe the principle of mutual economic benefit.[315]

As a result, the HG and IoC find themselves back to the negotiating table to re-evaluate their contractual relationship. The wording of the stabilization clause especially on the '*parties shall agree to make the necessary adjustments to the relevant provisions of this contract*' can be expressly interpreted to mandate the parties to renegotiate on the relevant provisions of the PSC as impacted by the changes.[316] Renegotiation of an existing contract might seem to be an amenable solution between absolute intangibility of contract as sought by an IoC and the need for a HG to maximize its economic dues over the natural resource.[317] Renegotiation as a concept in long term contracts, is embodied either through a contractual clause or an applicable law to which the supervening event rendering performance of obligations impracticable by either party.

[313] Clause 40, Model Production Sharing Contract, 2019.
[314] Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries*.
[315] Cameron P, *Stabilization in Investment Contracts and Changes of Rules in Host Countries*.
[316] Lukanda F,*Renegotiating investment contracts*.
[317] Lukanda F,*Renegotiating investment contracts*.

4.3.3 **Judicial Decisions on Contractual Changes**

However, this approach is limited in the purview of international arbitrators who are reluctant to adjust the sails of an existing contract without a specific basis. It has been opined international arbiters that,

> ' *it is not for the arbitral tribunal to question the motives or judgements of the parties, but to assess their rights and obligations in light of their legal significant acts or omissions. That is all; that is enough. To go beyond this role would be to betray the legitimate expectations reflected in the Parties' agreement to arbitrate, and indeed to impair the international usefulness of the arbitral mechanism. (...) The arbitrators cannot usurp the role of government officials or business leaders. They have no political authority, and no right to presume to impose their personal view of what might be an appropriate negotiated solution. Whatever the purity of their intent, arbitrators who acted in such a fashion would be derelict in their duties, and would create more mischief than good. The focus of the arbitral tribunal's inquiry has been to ascertain the rights and obligations of the parties to the particular contractual arrangements from which its authority is derived.*[318]

National courts of common law jurisdiction have placed great emphasis on certainty of contracts despite the outcomes sounding unfeasible on parties. The English courts have held that an '*an unanticipated eighty eight percent increase in the cost of goods to be supplied, that made the transaction unprofitable is not a ground to discharge a contract.*[319] Further, Lord Simon in *British movietownenews Ltd v. London and District Cinemas* observed that,

> '*The parties to an executor contract are often faced in the course of carrying it out, with a turn of events which they did not at all anticipate- a wholly abnormal rise or fall in prices, a sudden depreciation in currency, an unexpected obstacle to execution or the like. Yet this does not itself affect the bargain they have made.* '[320]

These decisions are part of the reason why parties choose international law so as to govern the investment agreements since national courts tend to apply the law in a strict manner. Besides that, International law provides a 'safer' and more reasonable investment ground to both the

[318] *Himpurna California Energy Ltd. v PT. (Persero) Perusahaan Listruik Negara*, Final Award of 4 May 1999.
[319] In *S. Instone & Co.Ltd v. Speeding Marshall &Co. Ltd*(1916),33 T.L.R.202.
[320](1952) A.C. 166 (H.L)

HG and IoC where a potential investment dispute may arise.[321] As regards the renegotiation of pre-existing contractual obligations, international law introduces a well-established principle of *rebus sic stantibus* as a basis for non-performance of a party's obligation to which either a HG or IoC can invoke in the circumstance of PSC.

International instruments embody the principle of rebus sic stantibus and further provides that where a fundamental change in circumstances occurs and which parties had not foreseen then it's a ground for termination.[322] Where a party meets these grounds, the party has a right to seek withdrawal or renegotiation of the contractual obligations.[323] However, courts have taken cognizance of the wording of Article 26-*pact sunt servanda* -and suggests application of the *rebus sic stantibus* principle is limited to unique cases for the purpose of shielding stability of international investment agreements.[324] In the *Gabcikovo-Nogymoros case*, the ICJ opined that:

> *A fundamental change in circumstances must have been unforeseen; the existence of circumstances at the time of the Treaty's conclusion must have constituted an essential basis for the parties to be bound by the treaty. The negative and conditional wording of Article 62 of the Vienna Convention on the law of treaties is a clear indication, moreover, that the ability of treaty relations requires that the plea of fundamental change of circumstances be applied only in exceptional cases.* [325]

However, no matter how well drafted, concise and considerate the terms of a stabilization clause are, this has not prevented HG from infracting on provisions of HGI either through changing of laws, regulations or taxes.[326] Worthy to note is that the concept of stabilization is inadequate and imperfect from preventing a HG from re-evaluating its economic engagement with an investor.[327] The tribunal in *Feldman Carpa v. Mexico* opined that,

> '*Governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, reductions or increases in tariff levels… Reasonable government regulation...cannot be achieved if any business that is*

[321] Lukanda F,*Renegotiating investment contracts*.
[322] Article 62, Vienna Convention as read with 6.2.1-2 and 7.1.7 of UNIDROIT Principles.
[323] Article 62, Vienna Convention as read with 6.2.1-2 and 7.1.7 of UNIDROIT Principles
[324] International Court of Justice in the case of *Gabčikovo-Nagymaros Project, Hungary v Slovakia* (1997).
[325] *Gabčikovo-Nagymaros Project, Hungary v Slovakia*, Judgment, Merits, ICJ GL No 92, [1997] ICJ Rep 7.
[326] Lukanda F,*Renegotiating investment contracts*.
[327] Lukanda F,*Renegotiating investment contracts*.

adversely affected may seek compensation, and it is safe to say that customary international law recognizes this.'[328]

This was further echoed in the case of *Pakerings- Compagneit v. Lithuania* where the court stated '*that States may exercise its sovereign legislative power, but must abide by stabilization provision and may not act 'unfairly, unreasonably or inequitably.'*[329]

From the above, international courts have not been consistent as regards the validity and effects of the stabilization clauses in HGI.

In essence, parties to a long-term investment contract are responsible for their individual interest and should take the necessary caution against any change in circumstances by renegotiating from the beginning.[330] Practice in the international business does not provide for an array of renegotiation provisions in contracts as the investors fear such an insertion would undermine the legitimate expectation of stability.[331]

It is an uphill task to attempt to alter the terms of a HGI as a result of changing circumstances. Mustafa Erkan, states that '*In a request for renegotiation, the party that wants to renegotiate the original agreement may invoke the rebus sic stantibus, while the defending party may insist on pacta sunt servanda.'*[332] The Kenyan context would face similar hurdles, and in the eventuality that a party invokes the stabilization clause, a legal interpretation that befits its intended purpose as between the parties should suffice. In addition to this, it is worth noting that although the stabilization clause greatly impacts the economic element of the project which most IoC bank on, the other side of the coin as regards stabilization clause is the sovereign duty of the state to protect its environment and uphold human rights more specifically the HG's right to political and economic self-determination.[333]

In such a situation, the HG is pressed to change its legislative framework either to incorporate a new law or repeal the same which in turn has effect on the petroleum sector and results into the IoC incurring additional costs.[334] For example, where international organizations such as UN, adopt a stabilization of greenhouse gases in the atmosphere, the resultant effect on this is the reduction of flaring of gases by IoC's during production of oil. This kind of directive will

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[328] International Centre for Settlement of Investment Disputes Case No ARB(AF)/99/1.
[329] International Centre for Settlement of Investment Disputes Case No. ARB/05/8.
[330] Lukanda F,*Renegotiating investment contracts*.
[331] Lukanda F,*Renegotiating investment contracts*.
[332] Erkan M, 'International Energy Investment Law, Stability through Contractual Clauses,*' Wolters Kluwer Law & Business*(2011),159.
[333] Article 1(2), International Covenant on Civil and Political Rights,1976.
[334] Erkan M, 'International Energy Investment Law, Stability through Contractual Clauses.'

have a direct financial impact on the IoC books of account, while the HG has a fundamental duty to protect its environment. The HG may invoke a legislation to this effect which may impact the IoC's financial investment accordingly. To this end, it's prudent to look at the economic equilibrium stabilization in a multi-faceted approach beyond just the financial impact it bears.

Chapter Five: FINDINGS, RECOMMENDATION AND CONCLUSION

5.1 Introduction

Having looked at Mozambique's R-factor fiscal regime in chapter 3, this chapter finds that indeed Kenya's R-factor would be more beneficial to the Government of Kenya in profit petroleum sharing with the IoC's. Additionally, it makes a finding that the R-factor fiscal regime would be more advantageous than the DROP fiscal regime. The chapter provides recommendation as to how GoK can re-negotiate their PSC's while concluding the study.

5.2 Findings

In the analysis of DROP and R-factor fiscal regime and the subsequent attempts for GoK to renegotiate the existing profit petroleum fiscal regime in a PSC, the research outlines the following findings.

5.2.1 R-factor regime has numerous advantages over DROP regime

The R-factor fiscal regime provides numerous advantages in its use as a design in the fiscal regime of a PSC. The R-factor closely relates to the profitability of the venture and in its computation as shown above it directly responds to the cost and revenue generated from the project.

Secondly, the adoption of R-factor as a fiscal regime tool is progressive in nature by ensuring that it captures the windfall situations that arise and reduces risk to the IoC. Additionally, the flexibility that the R-factor regime offers as regards to computation makes it more suitable to use than the DROP fiscal regime.

5.2.2 R-factor fiscal regime has resulted into increased profit petroleum by Government of Mozambique profit.

The study of Mozambique's R-factor fiscal regime has indeed shown that under the new EPCC signed post the 2014 change in petroleum laws has resulted into a more profit share by the Government in the EPCC's. As discussed, the use of R-factor in the production sharing in the EPCC's and the entrenchment of the terms of the R-factor fiscal regime has enabled the Government of Mozambique attain more profit petroleum in its EPCC's.

5.2.3 Sound legal and Institutional framework that enables the change from DROP to R-factor fiscal regime.

The study of Kenya's legal framework on the various contractual concept such as stabilization and change in law shows that Kenya has progressive and sound legislations on matters to do with contractual change. Both the repealed and current legislation, as enumerated in chapter 3, provides Kenya with a progressive position that enables it to renegotiate these PSCs in order to incorporate the change from DROP to R-factor. The NEB position provided by the stabilization clause is progressive in nature as it allows the parties to re-negotiate the terms of the PSC as they observe the principle of mutual economic benefits of the parties.

5.3 **Recommendations**

i. The need for GoK to negotiate on a NEB.

This study has shown that the existing petroleum legislative framework as read with the stabilization clause on the current PSC's enables the GoK to re-negotiate its terms based on the fact that a new law has been promulgated. The GoK and the various IoC's should proceed to make the necessary adjustments to the profit petroleum fiscal terms as they observe the principle of mutual economic benefit to both parties.

ii. Interpretation of terms of the PSC

The study has enumerated the various positions regarding the interpretation of terms of commercial contracts by courts and arbitral tribunals. As regards to the currently existing PSC's and in line with their terms especially the dispute resolution clause, GoK and the IoC's can try resolve the change in profit petroleum fiscal regime amicably. Where this is untenable, then it can be escalated to arbitration in accordance with the respective PSC.[335]

iii. The procedure to be used to trigger such re-negotiation

The study has enumerated that in order for a re-negotiation to happen, then a trigger event that adversely affects the parties' economic interests has to occur and, in this case, the ever-changing resource geology has a direct impact which can act as a trigger upon the correct resource classification. Secondly, since there exists no mandatory procedure that requires parties to trigger the events, GoK through the Cabinet Secretary responsible for matters of Petroleum can provide a notice or a communication in accordance with the terms of the PSC in order to re-negotiate the PSC. The Cabinet Secretary by dint of the Petroleum Act [336]is mandated to negotiate petroleum agreements on behalf of National Government. From the foregoing, he/she is the responsible party to trigger the re-negotiation process. In conclusion, the parties can issue a statement of the end result to be achieved by the parties.

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[335] Clause 40, Production Sharing Contract for Block 10BB and Block 13T.
[336] Section 18, *Petroleum Act* (Act No.2 of 2019).

5.4 **Conclusion**

Most HG's provide certain fiscal terms in the HGI in order to assist IoC make investment and provide the IoC with an opportunity to attain a return on investment. On the other hand, the IoC seeks to maximize the protection of such investment against the forecasted risk in a Country including acceleration on the rate of return and maximization of any windfall that may be generated from the investment.

From the IoC's standpoint, affixing the fiscal terms would be better from the earlier life of the investment when the HG is still in the process of attracting foreign investment rather than wait until they have sunk costs but yet to generate a return on the investment. The protection of the legitimate expectation of an IoC's investment due to the significant capital injection is a key factor in contractual arrangements.

Additionally, it is the IoC's key wish that the basis of their investment decision especially the fiscal terms are clear and predictable and shall not be subjected to changes by the HG arbitrarily. However due to the uncertainty and volatility of the extractive sector it would prove futile. Ideally negotiations of HGI does not capture all the surrounding issues that may impact the viability of the project, more often than not, the agreement is concluded with known assumptions such as capital costs, operating costs, geological reserves, rate of return, taxation among other economic models in play. If these circumstances and projections turn out to exceed party's expectation at the contracting stage, then either party more often than not develops a feeling of receiving the shorter end of the stick.

Furthermore, in the volatile character of the hydrocarbon industry especially the shift in market prices, the HG and IoC have not found established and predictable mechanisms of reconciling their economic differences that arise as a result of such volatility. From time immemorial HG have been faced with daunting challenges of how to adjust economic sails that capture a fair share of fiscal advantage accruing from the exploitation of a hydrocarbon while at the same time not undermining the stability of such an investment in light of its sustainability.

In as much the HG guarantees stability to an investment, the same does not negate its sovereign capacity to enact new laws and repeal old laws even those which may affect stabilization. Where new laws are enacted by the HG, the PSC is worded in a way that it ensures the changes fall within it scope or providing an avenue for amending such changes and where such changes materially affects either parties economic position, then a renegotiation of sorts shall be entered into so that the parties are returned to the previous economic position before the change.

This is the same position in the Kenyan context where the stabilization clause in the PSCs and also the current Model PSC provide that where the economic benefits of a party are substantially affected by the promulgation of the 2019 Petroleum Act, then the IoC's and GoK are to agree to make the necessary adjustments relevant to the PSC's while observing the principle of mutual economic benefit of the parties.

As discussed above, the DROP fiscal regime is insensitive to the surrounding changes such as market prices and costs unless the windfall tax is incorporated into it. This results into a party not fully gaining its due share from the hydrocarbon investment. Due to the dynamic environment in the oil industries where sub-surface risks such as global market prices playing a key role in the sector, it is imperative to adopt fiscal terms that are fluid in nature and is sensitive to the sub-surface risks that are experienced time and again.

The adoption of R-factor as a basis of profit petroleum sharing is progressive in nature due to the fact the regime is flexible and easily adjust its sails to the unforeseen circumstances in the sector. In addition to this, it is more likely to encourage the development of fields whose reserves are marginal in nature. Further, the use of R-factor is beneficial to the HG in that its design naturally allocates a higher proportion of profitability to the HG. It is further mechanized in a way that it enables the IoC recover the costs incurred in accordance with the cost recovery mechanism/framework while also providing an acceptable profit margin to be attained by the IoC in the development.

While it is imperative that to ensure that contractual terms are certain and stable, contracts ought to allow a certain degree of flexibility at the least to provide room for adjustments in the contractual relationship due to the unforeseen events that arise.[337]

No party to a commercial contract especially the long-term contracts spanning 15-30 years will keep their end of the bargain and continue implementing an obligation they committed to but to which they do not benefit from. More often than not, the party at a disadvantageous position would seek a renegotiation or a termination as a last resort.

As noted in Mozambique's case, the implementation of R-factor fiscal regime in the sharing of its production sharing with the concessionaires entitles the government to additional revenue. In addition to this, the consolidation of the R-fiscal regime in the model concession agreements

[337] Salacuse J, 'Renegotiating international Project Agreements,' 24 *Fordham International Law Journal* (2000),1327.

to which the terms are non- negotiable has spurred the oil and gas revenue due to the Government accordingly. Although, the wording of the stabilization clause of the EPCC and the fiscal stability provisions in the various legislations allows the Government of Mozambique to renegotiate its existing EPCC's, they are yet to re-negotiate the same.

Renegotiation provides a pragmatic attitude towards mitigating investment risks that arise from occurrence of unforecasted events in a contract. It is more desirable, realistic and easily enforceable as it secures either parties' interest in light of the inevitable circumstance that arose and were not forecasted prior to execution of the PSC.

Additionally, the wording of the stabilization clause in Kenya's PSC provides that in making of the necessary adjustments, it shall be cognizant of the mutual economic benefits of the parties. The import of this is that GoK cannot proceed to arbitrarily make changes to the PSCs which will be detrimental to the economic position of the IoC's. The GoK will have to ensure that the changes made especially in the fiscal regime of the PSCs will equally be beneficial to the IoCs. While interpreting the clause on mutual economic benefit from the PSC might theoretically seem like a straight jacket, the actual challenge would arise in the actual quantification and justification of what is due to benefit each party without having to negatively impact on either party's benefit. It would be an uphill task to attain a mutually beneficial position without negatively impacting either party in one way or another.

Worth noting and of concern but not within the scope of this research is the impact of stabilization clause on the health, safety and environmental provisions of the various PSC's already executed versus the health, safety and environmental provisions within the Petroleum Act and Model PSC.

The 2019 Act has attempted to address and put additional safeguards on environmental health and safety concerns within the upstream petroleum sector ranging from environmental compliance, waste management, safety, standardization and liability while the Model PSC has incorporated a whole provision on the contractor complying with environmental principles and safe guards in their performance of upstream petroleum operations.[338] Of particular interest would be the stabilization clause claim on the above environmental provisions on the existing PSCs in light of the heavy upfront capital expenditure versus the GoK inalienable right of

[338] Section 59 through to section 62 of the Petroleum Act as read with Clause 16 of the Model PSC 2019 looks at the Environmental, health and safety provisions that impact the upstream petroleum operations in Kenya.

protecting and safeguarding its health, safety and environment in light of the global outcry on environmental activities caused by exploration and exploitation of hydrocarbon.

In addition to this conundrum, would be the issue of economic stabilization in light of the GoK obligations concerning human rights and their resultant role in implementing international treaties concerning human rights and environmental protection in lieu of the executed PSCs. With such key responsibilities mostly resting with the HG and some international financial institutions being financial sponsors of such PSC's on one hand, while on the other hand, they strongly advocate for protection of human rights and environment through their policies and standards such as the International Finance Corporation performance standards on environmental and social sustainability. The above scenarios present a catch twenty-two situation for both the HG and the IoC in the full implementation of the stabilization clause.

In the international realm, the top international financial institutions advance negotiation as a means of resolving. Among them, the ICSID recommends that any dispute as between contracting states or parties regarding the interpretation or application of the convention must first be settled by negotiations and if that fails, then it will be referred to the International Court of Justice.[339] Further, contracting parties should be wary that contracts are not cast on stones and circumstance change and arise that often impact contracts. The parties to a contract should be able to provide reasonable conditions under which renegotiation can be achieved and more often it can be through the introduction of an equilibrium stabilization clause.

As enumerated above, the Model PSC,2019 provides for the adjustments to the relevant provisions of the contract where the promulgation of new laws substantially affects the economic benefits of a party. This is a progressive and pragmatic way of looking at contractual obligations in light of the uncertain circumstances in the extractive sector and specifically the oil and gas. In addition to this, the adoption of R-factor profit split and development cost uplift incorporated in the Model PSC,2019 will indeed generate additional revenue to Kenya as it is more economically efficient than DROP profit split combined with windfall tax.

To this end, in as much as there is no currently executed PSC under the 2019 Petroleum Act framework and that all existing PSC's are pegged on the repealed legislation, the benefits especially the fiscal regime enumerated above under the new Petroleum framework has major positive financial ramification on the GoK share of profit petroleum as compared to the existing PSC regime. The GoK should proceed and relook at their PSC relationship with the IoC's as

[339] Article 64, Convention on the Settlement of Investment Dispute.

well as trigger the stabilization clause in the PSCs to bring the IoC's back to the negotiating table and where such changes substantially impact the economic benefits of the IoC's, then necessary adjustments preferably a tradeoff can be made as they observe the principle of mutual economic benefit in order to effect these changes.

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APPENDICES

Appendix A: Similarity Report

Curiginal

Document Information

Analyzed document	Thesis Final.docx (D118059795)
Submitted	2021-11-10 09:01:00
Submitted by	
Submitter email	Castro.Ogutu@strathmore.edu
Similarity	10%
Analysis address	library.strath@analysis.urkund.com

Sources included in the report

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Appendix B: Ethical Clearance Confirmation

Strathmore
UNIVERSITY

15th September 2021

Mr Ogutu, Castro
castro.ogutu@strathmore.edu

Dear Mr Ogutu,

RE: Is Kenya Justified in Changing Its Profit Petroleum Fiscal Regime?

This is to inform you that SU-IERC has reviewed and **approved** your above **SU-master's** research proposal. Your application reference number is **SU-IERC1108/21.** The approval period is **15th September 2021 to 14th September 2022.**

This approval is subject to compliance with the following requirements:

i. Only approved documents including (informed consents, study instruments, MTA) will be used
ii. All changes including (amendments, deviations, and violations) are submitted for review and approval by SU-IERC.
iii. Death and life-threatening problems and serious adverse events or unexpected adverse events whether related or unrelated to the study must be reported to SU-IERC within 48 hours of notification
iv. Any changes, anticipated or otherwise that may increase the risks or affected safety or welfare of study participants and others or affect the integrity of the research must be reported to SU-IERC within 48 hours
v. Clearance for export of biological specimens must be obtained from relevant institutions.
vi. Submission of a request for renewal of approval at least 60 days prior to expiry of the approval period. Attach a comprehensive progress report to support the renewal.
vii. Submission of an executive summary report within 90 days upon completion of the study to SU-IERC.

Prior to commencing your study, you will be expected to obtain a research license from National Commission for Science, Technology, and Innovation (NACOSTI) https://research-portal.nacosti.go.ke/ and also obtain other clearances needed.

Yours sincerely,

for: Dr Virginia Gichuru,
Secretary; SU-IERC

Cc: Prof Fred Were,
Chairperson; SU-IERC

STRATHMORE UNIVERSITY INSTITUTIONAL
ETHICS REVIEW COMMITTEE
(SU-IERC)
15 Sep 2021
TEL: +254 (0)70303400
P.O BOX 59857-00200
NAIROBI-KENYA

Ole Sangale Rd, Madaraka Estate. PO Box 59857-00200, Nairobi, Kenya. Tel +254 (0)703 034000
Email admissions@strathmore.edu www.strathmore.edu