Acquiring and Divesting Upstream Oil and Gas Rights in Uganda

The pathway for sector growth

The upstream oil and gas sector represents the segment of the petroleum value chain that searches for, develops the necessary infrastructure, recovers and produces hydrocarbons. It is also known as the exploration and production (E&P) sector.

Early oil and gas exploration activities in frontier countries typically attract small sized companies which are more flexible to take on greater exploration risks compared to the bigger companies with inertia to assume projects whose probability of success is uncertain. These companies usually exit on making hydrocarbon finds by selling out their rights at a profit to bigger companies with the financial muscle and technical expertise to develop the discoveries.

None of the companies namely Heritage Oil and Gas Limited ('Heritage Oil'), Hardman Resources Pty Limited ('Hardman Resources') and Energy Africa Limited ('Energy Africa') that were involved in early exploration activities that led to crude oil discovery in Uganda still hold interest in the country's oil and gas sector. They sold out to bigger companies.

The small sized companies can also relinquish their rights in accordance with the terms of the relevant Production Sharing Agreements ('PSAs') in the event of unsuccessful exploration.

This publication discusses briefly Uganda's journey to petroleum discovery, the common methods for the acquisition and divesture of upstream oil and gas rights addressing the legal and tax consequences of each of the technique.

Journey to commercial crude oil discovery

The journey to crude oil discovery in Uganda in 2006 was long, winding and challenging. The existence of oil seepages along the shores of Lake Albert was first reported in 1925 by Edward James Wayland who was the Chief Geologist of Uganda's Colonial Administration. Several exploratory wells were drilled between 1926 and 1956 in the Albertine Graben but it was not until the 1990s that serious search efforts resumed.

Petrofina SA, a Belgian petroleum conglomerate acquired by Total S.A in 1999, signed a PSA with the Government of Uganda (GoU) in 1991 to carry out exploration activities in the Albertine Graben but withdrew 2 years later without any tangible works.

In 1997, the GoU entered into two PSAs with Jersey domiciled Heritage Oil and Australian incorporated Hardman Resources. Heritage Oil carried out the first seismic survey in Uganda in 1998.Hardman Resources did not start exploration operations until 2001 with its new partner Energy Africa. Heritage Oil continued with its exploration activities in conjunction with its new partner Energy Africa.

The promising prospects of these exploration operations and the rising crude oil prices enticed Irish founded Tullow Oil to purchase the entire shareholding in Energy Africa giving it a 50% stake in the blocks that Energy Africa co-held with Heritage Oil.

Hardman Resources found Uganda's first crude oil in June 2006 at the Mputa well. Other finds by Tullow Oil and Heritage Oil at the Kingfisher well followed and by 2009, Uganda had passed the threshold for commercial crude oil discoveries. In 2007, Tullow Oil purchased the entire shareholding of Hardman Resources. In 2009, Heritage Oil announced the proposed sale of its 50% stake in the blocks it held to Italian oil major ENI but Tullow Oil exercised its pre-emptive rights acquiring full ownership of the rights in these blocks. This transaction triggered off a long standing dispute for capital gains tax which Heritage Oil contested but was won by the GoU.

Tullow Oil divested two thirds of its interest in blocks 1, 2 and 3A to French oil major Total and the China National Offshore Oil Corporation (CNOOC) in 2012 with each party holding 33.33% and operator of one of the blocks. This transaction too triggered off a tax dispute that Tullow Oil eventually settled with the GoU. Tullow Oil intends to further divest its interests in blocks 1, 2 and 3A to remain with 11.76% stake.

In early 2015, 6 blocks were put on offer via Uganda's first competitive licensing round where Australian based Armour Energy Limited and Nigerian domiciled Oranto Petroleum emerged victorious and have already entered into PSAs with the GoU.

The acquisition and divesture of upstream oil and gas rights

There are 4 ways by which rights in the upstream oil and gas acreage are acquired and all have been tried and tested in Uganda. These are the direct acquisition of rights and obligations under PSA as also known as farm outs, farm downs or assignments, direct or indirect acquisitions of the shares of an entity with a PSA, first come first serve basis where an investor enters into a PSA with the government for any available acreage and licensing rounds where the oil companies bid competitively for the upstream oil and gas acreage on offer.

First come first serve is often at the inception of exploration activities when little is known about the country's geology and petroleum prospects. Competitive licensing rounds too are used to acquire acreage in countries that have been de-risked and whose oil and gas prospects are better known.

Farm outs and share sales however have to date predominated in Uganda as the means of acquisition and divesture of upstream oil and gas rights.

Farm outs or assignments

Interests in PSAs can be acquired or divested by way of farming out. Also known as farm downs or assignments, farm outs represent an arrangement where a PSA holder also known as a farmor divests part or all of their interests in the PSA to another party known as the farmee for a consideration. The divesting party farms out while the acquiring party farms in.

The consideration for farm outs takes the form of cash, carry or a combination of both. The cash consideration is in the form of a reimbursement of past costs to the farmor and sometimes a cash payment in excess of the past costs incurred. Under a carry, the farmee assumes the farmor's further exploration and development cost commitments under the PSA. Sometimes the consideration is deferred until the crystallization of certain milestones. We set out below a further explanation of the various forms of consideration.

- Cost reimbursement

The farmee reimburses the farmor all the past costs incurred during exploration operations. Given the consideration would match past costs, it is unlikely that the farmor would have any corporate income tax to pay on reimbursement.

- Upfront cash in excess of cost reimbursement

The farmee reimburses the farmor all the past costs incurred during exploration operations plus a premium. Given the consideration paid exceeds the past costs incurred, the farmor potentially has a 30% corporate income tax liability on the cash payment in excess of past costs.

- Hard carry

The farmee assumes a portion of the farmor's future exploration and development cost commitments under the PSA. However the carried costs are recoverable subsequently by the farmee from the crude oil share of the farmor when production begins. So if the farmee pays 100% to acquire a 50% share in a PSA, it is only entitled to recover 50% costs, the farmor being entitled to the balance.

- Soft carry

The farmee assumes a portion of the farmor's future exploration and development cost commitments under the PSA. These carried costs are however recoverable subsequently by the farmee from the crude oil share of the farmor when production begins. For example, the farmee incurs 100% of the cost of development in return for earning a 50% share in the PSA. The farmee is entitled to recover 100% of the costs out of future production allocated to the farmor under the PSA whose entitlement is reduced until the farmee has recovered its costs.

- Contingent carry reimbursement

The farmee can seek to reduce the level of risk associated with its investment into a PSA by deferring part of the consideration payable on the completion of the transaction. The deferred consideration element is paid later on the crystallization of predefined milestones.

Farm outs are also a means of mitigating sector risk. The oil and gas industry is characterised by systemic and diversifiable risks. Diversifiable risks are eliminated by diversification and these include exploration, development and political risks among others. Systemic risks cannot be avoided regardless of the level of diversification and include inflation and commodity price fluctuations etc.

The high risk of failure in upstream oil and gas ventures attracts companies to diversify interests as much as possible by holding smaller interests in several PSAs as opposed to holding the entire PSA rights alone.

Farm outs help oil and gas companies raise funds but also supplement their technical expertise through collaboration with other companies to fulfil work obligations under the relevant PSAs. The buyer could have the funds but lacks the acreage yet the seller is short on funds to meet the PSA obligations but has the PSA interest.

Countries that place onerous requirements on the transfer of PSA interests may deter the growth as well as the inflow of foreign direct investment to the oil and gas sector. Tedious requirements can include restrictive approval conditions on the assignment as well as punitive fiscal impositions that tax investments as opposed to profits.

In Uganda, the transfer of rights under a PSA requires the written consent of the Minister responsible for Energy in consultation with the Petroleum Authority of Uganda in accordance with section 87 of Uganda's Petroleum (Exploration, Development and Production) Act, 2013.This consent is required for both affiliate and non-affiliate transfers. The consent must not be withheld unreasonably though the Minister must inquire into the technical capacity, competence and financial strength of the person to whom the interest is being assigned.

If the value of the carry exceeds the past costs incurred, corporate income tax at the rate of 30% applies on the excess. Best practice however is to exempt carries from taxation as the value of the assumed exploration and development costs represents an investment to the oil and gas sector. Taxing carries is inconsistent with the aspiration of attracting foreign direct investment to the petroleum sector.

Share acquisition

Interests in Uganda's upstream petroleum acreage can be acquired or divested through the purchase or sale of shares in an entity that directly or indirectly (i.e. via a subsidiary) holds a PSA. This is what happened when Tullow Oil acquired the shareholding of Hardman Resources and Energy Africa. Tullow Oil bought out these entities at holding level.

A share transfer in a company that directly or indirectly holds a PSA too requires the written consent of the Minister responsible for Energy in consultation with the Petroleum Authority of Uganda in accordance with section 87 of Uganda's Petroleum (Exploration, Development and Production) Act, 2013. This consent is required for both affiliate and non-affiliate transfers. It must not be withheld unreasonably though the Minister must inquire into the technical capacity, competence and financial strength of the person to whom the license is being assigned.

Gains that arise on the direct disposal of shares in a company with a PSA in Uganda are ordinarily subject to corporate income tax at the rate of 30%. A disposal of shares can be by way of sale, transfer, assignment, distribution or destruction. The net gain on the disposal of the shares is the consideration less the cost of the shares. In the context of a share transaction, the consideration is the total amount received or receivable for the disposal, including the fair market value of any amount in kind at the time of disposal. The cost of the shares is the amount paid for their acquisition or incurred in respect of creating the shares including incidental expenditure of a capital nature.

Please note that gains that arise on intra company reorganisations may be exempted from corporate income tax.

The law also taxes gains on the indirect disposal of shares in offshore entities with shares in Ugandan companies holding PSAs with the GoU. It is not clear how gains arising in an offshore entity with interests in other non-Ugandan companies and assets can be allocated to Uganda..

Stamp duty at the rate of 1.5% of the consideration paid applies on the transfer of shares in Uganda. Stamp duty does not apply on intra company share transfers

in Uganda provided the conditions set out in the stamp duty law are satisfied.

First come first serve basis

First come first serve basis is the method that was being used in Uganda to award upstream oil and gas rights to companies until after the passing of the Petroleum (Exploration, Development and Production) Act, 2013. The law now provides for competitive licensing.

This method is usually used at the inception of exploration activities when little is known about the country's geology and petroleum prospects. As the name suggests, the first come first serve allocation method is where the company that makes its application first gets awarded the acreage.

It is important to note that the company does not automatically get the right to the PSA without meeting certain criteria or fulfilling certain legal and regulatory requirements.

Licensing round

An investor may acquire interest in Uganda's upstream oil and gas sector through bidding at a competitive auction for any acreage on offer. Uganda's first competitive licensing round was held in 2015 and the government has indicated that it intends to announce another one end of 2018 or in 2019. Australia based Armour Energy and Nigerian domiciled Oranto emerged victorious in the first licensing round and have already entered into PSAs with the GoU.

Also to note is that, there needs to be established an entity that holds the PSA interest. The Production (Exploration, Development and Production) Act, 2013 provides that no person other than a company incorporated or registered in Uganda under the Companies Act may enter into a PSA with the GoU. The entity established could be a subsidiary or a branch of a non-resident person.

Stamp duty at the rate of 1.5% on the issued shares of the subsidiary established to hold the PSA would be payable. ■

Contacts for this publication

Denis Yekoyasi Kakembo
(Author)
dkakembo@cristaladvocates.com
+256 751 834 168

Denis leads the energy and tax practice at the firm. A qualified Lawyer and Chartered Accountant, he is a UK trained energy, tax and investment professional with vast experience serving various industries but notably the energy sector in Sub Saharan Africa.

Prior to joining Cristal Advocates, Denis had worked for close to 10 years with Deloitte an international professional services firm where he started his career and rose to senior managerial positions. He has lived and worked in Uganda, Kenya, Tanzania and the UK.

He holds a Master of Laws Degree in Petroleum Taxation and Finance from the University of Dundee in the United Kingdom and various other qualifications. He is widely published and a regular commentator in the local, regional and international media and speaker at various conferences regarding the taxation and financing of the energy projects and other businesses. ■

John Teira
jteira@cristaladvocates.com
+256 704 493 997

John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

He holds a Bachelor's degree in Law, the Post Graduate Diploma in Legal Practise from the Law Development Centre and various other qualifications.. ■

Contacts for this publication

Francis Tumwesige Ateenyi
ftumwesige@cristaladvocates.com
+256 702 540 936

Francis leads the litigation and dispute resolution practice at the firm. He is passionate about the evolving oil and gas national content development. He is an Advocate of the High Court of Uganda with expertise in oil and gas, infrastructure and dispute resolution. He has been part of teams advising on projects in Uganda, Tanzania, Mozambique and South Africa. He specializes in regulatory compliance, national content, health and safety and dispute resolution.

He joined Cristal Advocates from Kizza, Tumwesige, and Ssemambo Advocates. He previously worked with the Advocates Coalition for Development and Environment (ACODE). He also undertook a traineeship with the oil and gas division of Webber Wetzel in Johannesburg, South Africa.

He holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom and various other qualifications. ■

Dickens Asiimwe Katta
dasiimwe@cristaladvocates.com
+256 772 370 021

Dickens leads the firm's oil and gas practice. His core practice is in oil and gas but also has experience in local and international arbitration, mergers and acquisitions, private equity, energy, project development and finance, infrastructure, construction and real estate law.

Prior to joining Cristal, Dickens worked as the Company Secretary of the Uganda Refinery Holding Company Ltd (URHC) which represents the Government's interests in the Uganda Refinery Project and is charged with managing Uganda's 29sqkms Petro based industrial park.

Dickens also served as the Company Secretary of the Uganda National Oil Company (UNOC) - a company charged with handling the State's Commercial interests in the Oil and Gas industry in a Joint Venture with Total E&P, CNOOC and Tullow Oil from its inception until September 2016. Dickens was instrumental in UNOC's formation and initial period of operation and also worked as its Head of Contracts, Negotiations and Advisory until April 2018.

Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy and Mineral Development for five (5) years where he was charged with evaluation of oil and gas and infrastructure transactions, negotiation of Production Sharing Agreements, host implementation agreements and joint venture agreements. While there, he was the secretary of the team that put together the midstream petroleum law and was also also part of the team that put together the upstream law and the attendant regulations.

He holds a Masters of Laws Degree in Petroleum Law and Policy from the University of Dundee, United Kingdom and various other qualifications. ■

Contact us

Cristal Advocates
32 Lumumba Avenue
4th Floor, Padre Pio House
Lumumba Avenue
P.O. Box 1769 Kampala, Uganda
Tel: +256 (414) 671 274
Email; admin@cristaladvocates.com
www.cristaladvocates.com