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East African Crude Oil Pipeline Project

Overview of the Legal, Tax and Commercial Issues

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1. Introduction

It seems increasingly likely that the long awaited Uganda's crude oil final investment decision (FID) will be made this year. FID is the point at which the oil companies and government (via the Uganda National Oil Company) will decide to move ahead with developing the necessary infrastructure for crude oil production. FID will be a key milestone as in the first 3 years even before first oil flows there will be unprecedented capital investment of over USD 10 Billion representing more than a third of Uganda's gross domestic product (GDP) currently at USD 30 Billion.

Crude oil discoveries are worthless unless monetised. Uganda therefore requires an investment decision for the construction of a crude oil pipeline and refinery though the decision on the pipeline is more critical for now to unlock the FID for the crude oil field production facilities. An Intergovernmental agreement (IGA) between the governments of Uganda and Tanzania providing the overarching regulatory framework for the crude oil pipeline was finalised in 2017. The conclusion of the pipeline Host Government Agreements (HGAs) and Tullow Oil dilution of stake in Blocks 1, 2 and Kingfisher are pending to enable the finalisation of a bundle of agreements including but not limited to cost allocation, crude oil offtake and purchase, crude oil transportation, lifting, production metering and allocation which must all be in place before FID.

Cross border crude oil pipelines such as the planned East African Crude Oil Pipeline present unique challenges. This pipeline will cover over 1,400 kilometres, from Hoima in Uganda to the Port of Tanga in Tanzania. Both these countries have different regulatory and tax regimes. Political and economic considerations related to cross border pipelines loom large, compared to other undertakings, combining to create an intricate landscape that must be navigated to have a commercially viable and bankable project.

In this publication, we provide an outline of some of the key legal, tax and commercial considerations to take into account in establishing the appropriate regulatory and operational architecture for the planned East African Crude Oil Pipeline.

2. Cross border crude oil pipeline features

Cross border pipelines have three key features: the long life of projects, the economies of scale and state involvement.

a) Long life of projects

Crude oil pipelines usually have an operating life in excess of 20 years imitating the crude oil production profile. Once built and commissioned, pipelines are fixed and crude oil can only be transported via this static path. With the sunk investment, the bargaining power of the pipeline developer weakens vis a vis the government and other stakeholders. This can be aggravated by adverse changes to legislation and economic conditions. To the extent possible, pipeline project agreements should be sustainable over a long period of time, balancing the interests of key stakeholders through changing circumstances though this aspiration is difficult to achieve. Pipeline developers in many emerging economies insist on the inclusion of stabilisation clauses in pipeline project agreements to manage the risk of government exercise of its sovereign power to their detriment in the long period of building, operating, maintaining and decommissioning the pipeline.

b) Economies of scale

The decision on pipeline capacity must be made before construction commences because once a pipeline is built, it can be difficult to increase its capacity to transport more crude oil losing out on the benefits of the economies of scale if additional reserves of crude are discovered. Pipelines involve large upfront investment. The structure of pipeline costs is characterised by high fixed costs and low variable costs. It is clearly more beneficial in terms of unit transport costs to have one pipeline of 24 inches than three smaller ones. Because of the high fixed costs, full capacity operation is extremely important.

c) Government involvement

Governments participate in the regulation, development and operation of crude oil pipelines. They can take up an equity stake in the project company and contribute to the project development costs in cash or in kind. The participation of the government as a commercial investor in pipeline projects can be a source of conflict with the private developers because of diverging interests. A private investor is focussed on earning a return on investment that is commensurate with the risks undertaken. A government, in contrast, seeks to balance both commercial and non-commercial considerations.

The government plays a regulatory oversight role in promoting best practices that safeguard the environment. It must protect the well-being of its citizens, stimulate economic growth, maintain public order and guard sovereignty. The pipeline is a natural monopoly. In the absence of regulation, there can be market failure if the pipeline developers do not allow third party access to the crude oil pipeline on equitable terms.

3. The Intergovernmental Agreement and Host Government Agreement

The IGA represents an international treaty or agreement between or amongst the countries across which the crude oil pipeline traverses. An IGA between the governments of Uganda and Tanzania providing the overarching regulatory framework for the crude oil pipeline was concluded in 2017. The IGA deals with issues that concern the pipeline infrastructure as a whole in the countries hosting the pipeline. The HGA is an agreement between project investors and the respective pipeline host governments. The HGA generally expands on some of the issues identified in the IGA but they are both aimed at facilitating the implementation of crude oil pipeline projects and should be consistent.

The IGA and HGAs spell out obligations that the respective host states must fulfil in relation to the pipeline project. The host states make commitments under these agreements that they are obligated to honour. They commit to establish and maintain a favourable environment to enable pipeline project implementation. The host states are keen to include provisions in these agreements that enhance economic prosperity, safeguard the wellbeing of citizens and national sovereignty. It is important that both the IGA and HGA are clothed with the force of law to ease the implementation of the terms therein in the respective host states.

Some of the salient issues covered by the IGA and HGA include but are not limited to:

a) Investment protection

Investment in pipeline projects attracts scrutiny because of the heightened sovereign risk exacerbated by its long term profile from construction to operation and decommissioning. Project sponsors and lenders consider from the very outset ways of managing the exercise of government legislative prerogative that may subsequently erode the commercial viability of the pipeline project as initially evaluated.

Stabilisation clauses are commonly included in both the IGA and HGA to manage sovereign risk. Stabilisation clauses represent commitments by the host states and project parties not to revise the terms of the project agreements (and governing laws) without the consent of the other parties. Project sponsors and lenders are keen to anchor the terms of the project agreements based on the legal and fiscal regime in effect at the time of the investment to ensure predictability.

Stabilisation clauses have a long history and have evolved over time. Initially, host states would be precluded from amending legislation that would impact the investments in question but this was objected to as a restraint on the sovereignty of countries. Stabilisation clauses today outline the need to preserve the original balance of economic returns accruing from the project in the event of change in the law rather than restraining the revision of legislation.

b) Taxation

Given the specific features of pipeline projects, both the IGA and HGA normally provide for a special taxation and fiscal regime. It is especially important that the pipeline tax base is determined in these agreements as multiple layers of taxation or uncertainty around how income tax applies to each country's portion of the pipeline are likely to significantly weaken the case for investment and deter lenders.

The VAT regime applicable to pipeline projects must also be given special consideration. Given the long lead time between construction and operations, the VAT expense during the construction stage can be significant unless exempted or relieved. Huge input VAT can also be incurred at the operational phase (as the provision of international transportation is usually zero-rated) creating VAT repayment claims traditionally delayed in many emerging economies. These issues need to be appropriately handled in the pipeline project agreements.

The import duty regime applicable to pipeline projects too requires careful thought. The imposition of import taxes and associated levies on goods, equipment and related inputs imported for pipeline construction and operation can increase the overall costs and affect project viability. The position adopted by many developing countries for their infrastructure projects is to exempt such ventures from import duties and associated levies so as to keep the building costs low and viable. Crude oil being transported through the pipeline is generally treated as goods in transit so it is not necessary to formally import it for customs purposes in transit countries.

c) Transit rights

The freedom to convey crude oil in the pipeline system is a basic right that host countries must guarantee and respect. Both the IGA and HGA must not only set out this right but also provide for its protection by guarding against discrimination either by the host governments or third parties on the basis of origin, destination or ownership as well as eliminating any delays and discrimination on the basis of pricing. There should also be uninterrupted supply of crude oil even when the parties are trying to settle a dispute amongst themselves. A party may restrict transit, but only after giving notice to the other states.

d) Land rights

The project developers require land not only providing the right of way for the pipe but also for usage for the operation of the pipeline including the construction of pumping facilities. Providing investors land rights in a fair, transparent and enforceable manner and on clear terms and conditions is essential for avoiding future disputes. In the context of land rights, it is essential to set out and understand what land the pipeline consortium has a right over in the context of building energy transport facilities and what qualifies as land rights in the context of such facilities.

e) Transit tariffs

Transit fees to allow the crude oil throughput in the pipeline section hosted by another country is always a controversial subject. Issues around transit fees are the major source of conflict between countries and disruption of the throughput when operations begin. It is imperative that a reasonable yet competitive transit tariff is agreed upon by both the governments of Uganda and Tanzania that will allow the project to remain viable in the current and future environment.

f) Dispute settlement

It is critical that there are robust means of resolving disagreements. Unresolved disputes have the potential to derail pipeline operations and this underlines to both governments and pipeline developers the importance of having in place clear strategies for settling disputes that must be incorporated in the respective project agreements. Expert determination can be used in disputes requiring expert or technical input, but the parties need to agree in writing on the matters that are covered by this. Arbitration is the technique of choice for dispute resolution in the international oil and gas industry. It is legally binding and the consequential awards enforceable in foreign jurisdictions. Parties

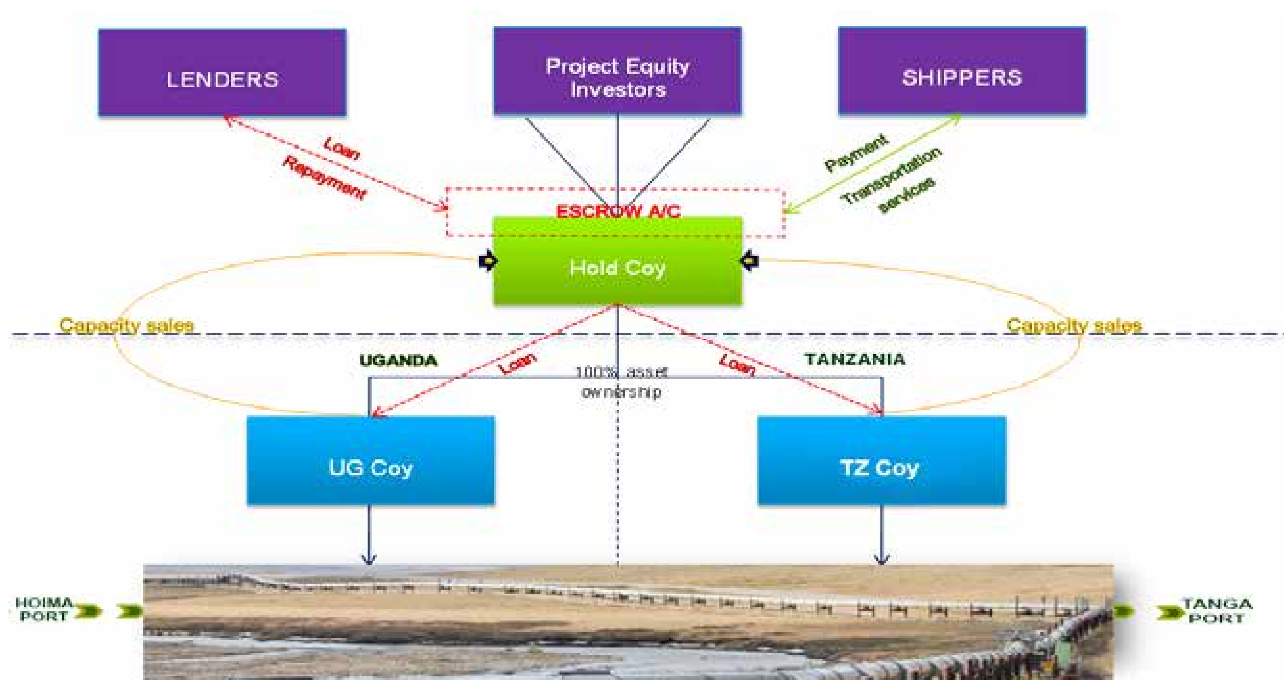
can choose their arbitrators, the extent of their arbitration process as well as the venue and forum of arbitration though it is fairly expensive.

4. Local content

Local content is the value add brought to a host nation through pipeline construction and operation. Strategies devised by countries to enhance local content include simple contractual requirements that favour the use of local goods and services, imposition of training obligations, employment of locals and preferential regulation and taxation of local companies over foreign. Contractual or legal provisions can also prescribe for technology transfer. Incentives may similarly be provided to foreign investors who re-invest their profits domestically as a strategy of anchoring local content. Pipeline project agreements usually contain provisions on local content consistent with the requirements of the applicable sector local content regulations.

5. Typical project structure

Project finance or non-recourse financing is typically used to fund pipeline projects and this can result in a dual layer structure as illustrated by the diagram below. In the dual structure, there are separate local companies owning and providing capacity in the pipeline in each country crossed, and a parent company in a third jurisdiction providing shipping services to third parties and receiving payments from them for providing this service.



The local companies receive payment from the parent for providing capacity, whilst the parent provides the actual transport service. The reason for this is that it is more convenient for the lenders to have a single company to contract with customers because this gives them ready access to receipts. This also enables the lenders to have access to cross-border remedies in case of non-performance by the borrowers: in short it enhances their security. Usually receipts are paid by customers into an escrow account and funds distributed from there to service the debt with the balance being paid to the parent.

Though it is possible that a contractor party to a Production Sharing Agreement (PSA) may wish to directly hold the interest in the export pipeline, it is more likely that a separate corporate holding structure is established, particularly if third party financing is to be obtained. In this case the PSA contractor parties pay some kind of transport fee or tariff to the pipeline operator(s).

6. Defining the delivery point

Under most PSAs, contractors are not allowed a tax deduction or cost recovery in relation to costs of transport beyond the Delivery Point. It is usually provided in the PSAs that the Delivery Point is to be agreed upon between the contractor and the government. Given the high cost of an export pipeline, denial of cost recovery or tax deductions for the cost of transport to the port of export may have a significant impact on project economics.

7. Clarity on the tax base

Determining the tax base in each jurisdiction crossed by the pipeline is a critical issue. Pipeline investors look to avoid multiple layers of taxation or uncertainty on how income tax applies to a project. For this reason, pipelines are often owned and / or operated by local legal entities in each jurisdiction which they cross, for example the CPC pipeline is owned by a Kazakh legal entity up to the Russian frontier with the Russian section of the pipeline owned by a Russian legal entity. The benefit of this approach is that the tax base can be more clearly defined as income attributable to that country less financing, operating costs and tax depreciation attributable to that portion of the pipeline running through the jurisdiction. The use of a single entity covering more than one jurisdiction can lead to less certainty over the attribution of profits to the jurisdictions which the pipeline crosses and can also potentially occasion tax leakage.

8. Commercial issues around financing

Typically pipeline development structures use significant levels of debt finance. Care needs to be taken to ensure that local companies are not thinly capitalized or legislation with respect to the tax deductibility of interest payments takes into account the sector specific circumstances.

Withholding tax (WHT) on loan interest repayment can also be a significant issue. The pipeline developing parent company may likely be tax resident in a location which does not impose WHT on interest payments. Lenders typically require gross-up of interest payments otherwise. The local companies, on the other hand, may be required by legislation to apply WHT to interest payments to the parent. The possibility of getting WHT rate reductions under a tax treaty can influence the choice of jurisdiction to locate the parent. WHT imposed at the local company level is a cost to the project and the impact on economic viability requires careful consideration.

9. Recovery or mitigation of input VAT

Pipeline construction and operating costs are significant. Both locally procured and imported goods and services can give rise to input VAT unless relieved or modified, whilst the pipeline's revenues when they are eventually generated are usually zero-rated as they relate to international transport services. If input VAT is incurred and not relieved, this can create an issue in both the construction and operation stages as significant repayment claims may need to be handled by the tax authorities in pipeline jurisdictions. The approach taken by most countries undertaking pipeline projects is to relieve the same from VAT for inputs used in pipeline development and operation.

10. Classification of services for VAT purposes

In the envisaged structure above, the parent company can invoice its customers for transporting oil from Uganda to Tanga port in Tanzania. Payments would apply to the whole distance and clearly be classified international transportation which is zero rated for VAT purposes in Uganda and Tanzania. Consideration would need to be given to whether the parent is obliged to register for VAT in the jurisdictions which the pipeline crosses. This could be covered in the HGAs. So far as the local companies are concerned under the illustrative structure outlined in the diagram above, they may sell capacity to the parent rather than transportation services per se. If the local companies are obliged to charge VAT on these services this becomes a cost to the parent, which may not be recoverable impacting the economic viability of the project.

11. Customs duty and VAT on imported goods

The imposition of customs duties and VAT on imports of goods in relation to pipeline construction and operation can increase the overall cost of the project and impact viability. Certain goods are exempt from import duties under "Exemption Regime" of the East African Community Customs Management Act 2004: equipment and inputs (not including motor vehicles,) imported by a licensed company for direct and exclusive use in oil, gas and geothermal exploration and development upon recommendation by a competent authority of a Partner State. It is sensible to extend this approach to inputs imported for pipeline construction and operation.

12. VAT treatment of exports

Exports of crude oil via the pipeline will be zero-rated for VAT, however the relevant tax authorities may require evidence of their having been exported. A mechanism needs to be developed to enable the fact of export to be validated and the pipeline project agreement can document this clarity.

13. Conclusion

The creation of an efficient structure to build, own and operate the pipeline requires careful consideration of the current legislative framework in Uganda and Tanzania. To ensure the viability of the project, we consider that there is a powerful case for changing the legislative environment in each jurisdiction via the IGA/HGA framework and changes to local law and domestic tax rules.

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At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

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From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

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