Is Uganda taxing capital for oil investment?

Hot Topic

The business community which had been hopeful that Uganda's oil sector would eventually take off this year with the final investment decision ("FID") may have to wait longer following the recent termination of Tullow Oil's intended sale of oil interest ("PSA") stake to French oil major Total and China National Offshore Oil Corporation ("CNOOC"). Total has also now suspended procurement activities in relation to the East African Crude Oil Pipeline. Both statements from Tullow and Total noted that disagreements with the government over the tax treatment of this deal led to its collapse. The FID for Uganda's oil project may remain outstanding until this deal mainly intended to help Tullow raise finances for investment in the project completes.

When Tullow indicated that it will re-initiate the sale in due course, Total was categorical that it would exercise its right of first purchase at any subsequent sale. Unless an agreement is reached between the government and the oil companies ("IOCs"), the tax disputes relating to this transaction are likely to endure delaying Uganda's oil production further which is costly to both the government and the IOCs. While it may be tempting to apportion blame for the current impasse, this misses the point. The elephant in the room is how the oil tax regime is affecting project commercial viability which fortunately both the government and oil companies can work out scientifically with verifiable economic modelling. A strategic commercial outlook and appropriate alignment of issues can also help resolve the stalemate.

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Tax disputes on PSA disposals are common in countries with new oil discoveries that see an increase in PSA transfers and sometimes misunderstand these as happening entirely for profit maximisation. Kenya, Uganda, Mozambique and Tanzania have all at one time attempted to tax or (indeed taxed) the supposed windfall gains on PSA transfers. With experience that such measures can adversely affect sector capital inflows, Kenya revised its oil tax regime aligning it to the commercial realities of oil interest disposals.

If Uganda had maintained its 2008 oil tax regime but with modifications, the current disagreements would be minimal. The rules introduced in 2008 adopted a "step in shoes" approach to PSA disposals. The transferor/seller was not taxed on any gain, but the transferee/buyer inherited the seller's undepreciated costs for tax purposes. CNOOC and Total have disagreed with the government for denying them tax relief on acquisition costs if they went ahead with the Tullow transaction. Anticipating that Heritage would dispose of its PSA interests, the law was amended in 2009 to tax arising gains. While it is fair to tax capital gains, this amendment did not consider the various reasons for PSA disposals. Though IOCs sometimes dispose PSA stake for profits (which clearly was Heritage motive), they are usually intended to raise funds for exploration and develop¬ment operations as well as mitigating sector risks by diversifying a portfolio of projects. The current tax regime unfortunately taxes PSA disposals uniformly regardless of objective.

The Uganda National Oil Company ("UNOC") recently announced that it had applied for an oil exploration license. Given its current lean balance sheet, we anticipate it will dispose of part of its PSA stake to another IOC in exchange for financial support to meet its PSA work commitments. Under the current tax regime, this support in kind to UNOC would be treated as consideration and oddly subject to 30% income tax even though UNOC would not have received any of it in cash. We believe it is not government objective to tax capital for investments but some provisions in the law give this result. There are other instances inadvertently taxing capital earmarked for investment.

President Museveni advised government agencies in 2014 against taxing capital earmarked for investment. It was prudent to the President if only the income deriving from these investments was taxed. Though the oil tax regime was amended in 2015 to address the President's concerns, there are still gaps in the law to plug to achieve an optimal tax position. Both the government and IOCs should therefore relax their irreducible demands and have an objective evaluation of whether indeed Uganda's oil tax regime dwindles sector profitability. This discussion will once and for all resolve the outstanding tax issues. Otherwise, investors currently evaluating whether to participate in the ongoing Uganda oil licensing round will raise the same.

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Relying on press reports, the government demanded for taxes amounting to $167 million from Tullow Oil on its cancelled sale as well as denying Total and CNOOC tax relief on the would be acquisition costs. The IOCs have maintained that this position suppresses project returns below the target for their shareholders to sanction the FID. If the law can be revised ensuring that only profits are taxed, Uganda's oil industry will thrive. Many qualified Ugandans have been laid off or cannot be absorbed in the sector because of the inactivity from the current stalemate.

According to our workings, the government loses in excess of $ 300 million per year in eroded value of its expected oil project revenues with the delays. IOC losses are significantly lower but they are also under less financial pressure because they have oil producing assets in other countries generating cashflows. Mozambique had its FID recently and Kenya is on the brink. Investment capital is highly mobile and Uganda will lose out to these projects unless there is a quick settlement. There is also investor fatigue having waited for so long for Uganda's project. The government projects that the oil sector will create over 160,000 Jobs. Assuming an average monthly pay of $ 500, the government would collect a minimum of $ 307 million in pay as you earn taxes alone per year. This is double the tax that the government demanded leading to the collapse of Tullow's stake sale further delaying FID. There is therefore every reason for the government to come to agreement with the IOCs even if it means yielding to some of their tax demands. It can be validated scientifically that the aggregate economic benefits significantly outweigh the value of taxes currently demanded by the government or hoped to save in the future that is stalling the progress of the country's oil sector.

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Denis is the Managing Partner at Cristal Advocates where he also leads the energy and tax practice. He is qualified both as a Lawyer and Chartered Accountant with vast experience serving various industries in Sub Saharan Africa. Before joining Cristal Advocates, he had worked for close to 10 years with Deloitte and Touche where he started his career and rose to senior managerial positions.

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.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

He holds a Master of Laws degree in Petroleum Taxation and Finance from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

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Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

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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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.

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Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

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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.

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