GIDE
GIDE LOYRETTE NOUEL

EY
Building a better working world

The Federal Republic of Somalia

Workshop for presentation of the Provisional Report

Review of the legal, regulatory and fiscal framework of Somalia for the Petroleum Sector

Fiscal terms and economic results

Nairobi, June 2 -3 2016

Table of contents

1	Introduction
2	Presentation of the new fiscal terms
3	Analysis of the attractiveness and competitiveness of the new fiscal terms

Basis of preparation

- EY's work and analysis relating to this study was based on EY's research of available documents representing the existing fiscal environment for petroleum sector in Somalia. The results of our research included both the available pieces of Somalia's legislation and analytical information. Due to the lack of any official on-line sources of legislation, some of the documents obtained in the course of our research are unofficial and would require verification by the World Bank. In case of discrepancies between the official legislation and the information that EY possesses, our analysis and conclusion may need to be revised. Below is the list of analyzed documents:
  - **The Transitional Federal Charter of the Somali Republic, 2004**

    [http://www.ilo.org/dyn/travail/docs/2177/Transitional%20Federal%20charter-feb%202004-English.pdf]
  - **The Provisional Constitution of Somalia, 2012**

    [http://www.webcitation.org/6Bct8nAdJ]
  - **The 2008 Federal Petroleum Law of Somalia**

    [was made available to us by GIDE LOYRETTE NOUEL]
  - **The Model Production Sharing Agreement of Somalia dated 2007 (that adopted/approved in 2008)**

    [was obtained through EY's access to the Petrocash © database: www.petrocash.com]
  - **Information contained in the Wood Mackenzie © database**

    [was obtained through EY's access to the Wood Mackenzie © database: www.woodmac.com]
  - **Information about peer countries**

    Information about peer countries was based (as applicable) on general applicable terms in the countries, model production sharing contract or summary terms available within EY and/or contained in the Wood Mackenzie © database, Petrocash © database. Where terms have been biddable, we have provided terms that have been announced or discussed for a particular project in a country to provide a reference for comparative purposes.
- Our analysis for the purpose of this inception report was aimed at analyzing the federal legislation and provisions, and our view on Somalian petroleum sector was from the perspective of the federal government.
- Please note that the comparative assessments of individual fiscal features should not be considered on a stand-alone basis but in conjunction with all other fiscal terms representing the overall applicable fiscal regime in the benchmark countries.

1. Introduction

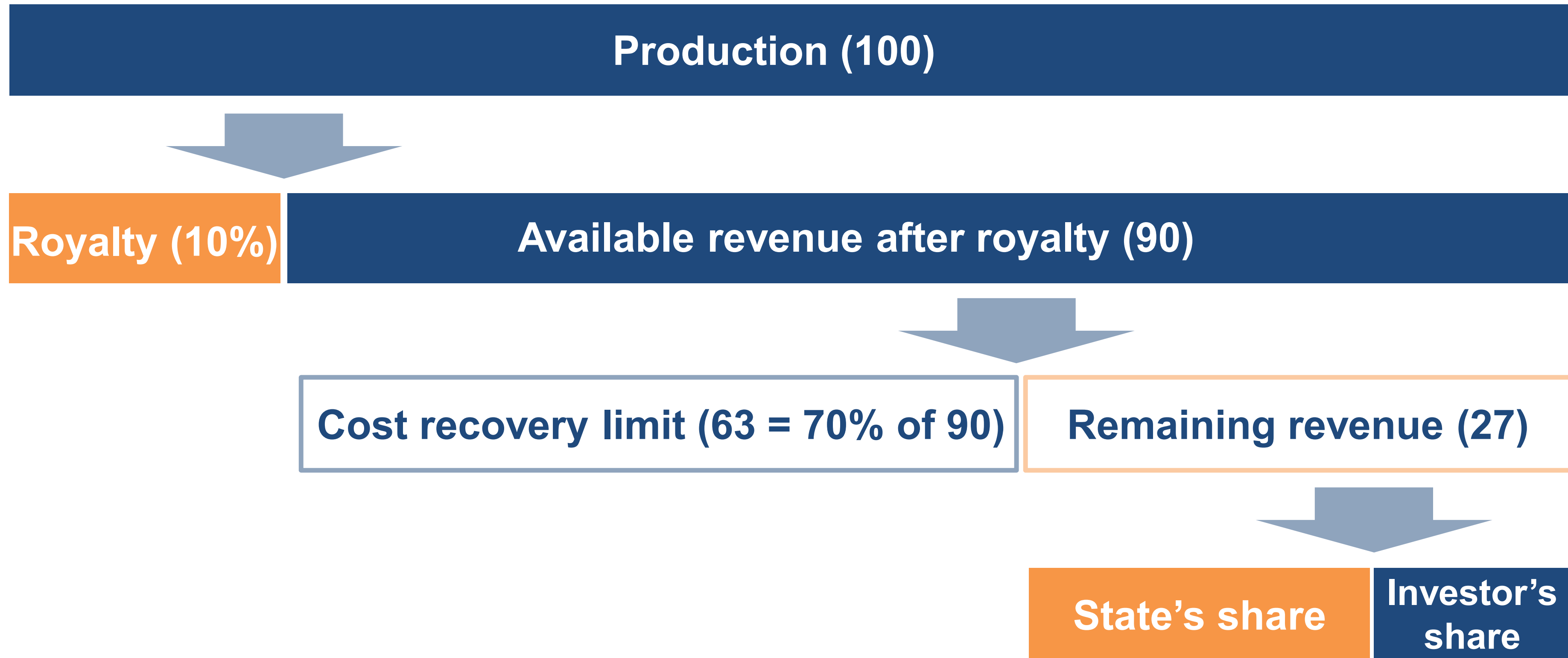
Inputs for the Provisional report

The proposed fiscal framework is based on the following principles which reflect the objectives for the updated oil and gas fiscal framework in Somalia:

- Progressive taxation of petroleum upstream operations (i.e. taxation is proportionate to the profitability of the operations)
- Simple-to-administer regime
- Hybrid regime: single source of petroleum legislation and fiscal terms (i.e. petroleum law) with some variables to be specified in a petroleum contract
- Fiscal terms applicable to petroleum upstream operations will be solely those envisaged by the petroleum law and the petroleum contract; no other taxes, fees or similar payments will be applicable to petroleum upstream operations
- Attractive fiscal terms compared to the neighboring countries taking in account the frontier status of the Somalian petroleum opportunities

2.
Presentation of the new fiscal terms

Overall revenue sharing



Summary of existing & updated fiscal terms

<table>
<tr><th>Fiscal feature</th><th>Current fiscal terms (Model PSA)</th><th>Proposed new fiscal terms</th></tr>
<tr><td>Specific oil and gas fiscal terms</td><td></td><td></td></tr>
<tr><td>Signature bonus</td><td>Biddable/negotiable</td><td>Biddable, but minimum US$ 200k. Non-recoverable</td></tr>
<tr><td>Production bonus</td><td>Fixed and detailed (5-tier scale linked to cumulative production). Recoverable: yes</td><td>Not applicable in the proposed framework</td></tr>
<tr><td>Rentals</td><td>Fixed and detailed. $10 per sq. km during exploration, $100 per sq. km during development and production . Recoverable: yes</td><td>Unchanged</td></tr>
<tr><td>Training contributions</td><td>Fixed and detailed.
$100k per year through the term of the agreement
Recoverable: yes</td><td>US$ 200k per year. Recoverable. The contribution has been increased to cover for the costs that the SPA will incur to audit operator’s accounts and fiscal calculations.</td></tr>
<tr><td>Royalty</td><td>Fixed and detailed
Linked to daily production and prices (P). The royalty rates for natural gas are the same as those for crude oil with 1 bbl = 4 Mcf and the gas price on a 10:1 basis.
<table>
<tr><th>BOPD | $/ bbl</th><th>P <35</th><th>35 < P < 45;</th><th>45 < P < 55</th><th>P > 55</th></tr>
<tr><td>First 25k</td><td>2%</td><td>4%</td><td>6%</td><td>8%</td></tr>
<tr><td>25k+ – 50k</td><td>4%</td><td>6%</td><td>8%</td><td>10%</td></tr>
<tr><td>50k+ – 100</td><td>6%</td><td>8%</td><td>10%</td><td>12%</td></tr>
<tr><td>100k+</td><td>8%</td><td>10%</td><td>12%</td><td>14%</td></tr>
</table></td><td>Flat rates:
10% for oil and condensates
5% for natural gas</td></tr>
<tr><td>Cost recovery ceiling</td><td>40% (oil) /60% (gas) net of royalty</td><td>70% for both oil and gas</td></tr>
<tr><td>Brief cost recovery rules</td><td>Subject to cost recovery ceiling, all major costs are allowed for recovery in full without additional limitation</td><td>Unchanged</td></tr>
<tr><td>Profit petroleum sharing</td><td>Linked to daily production and prices (P). State’s share
<table>
<tr><th>BOPD| $/ bbl</th><th>P <35</th><th>35 < P < 45;</th><th>45 < P < 55</th><th>P > 55</th></tr>
<tr><td>First 25k</td><td>55%</td><td>60%</td><td>65%</td><td>70%</td></tr>
<tr><td>25k+ – 50k</td><td>60%</td><td>65%</td><td>70%</td><td>75%</td></tr>
<tr><td>50k+ – 100</td><td>65%</td><td>70%</td><td>75%</td><td>80%</td></tr>
<tr><td>100k+</td><td>70%</td><td>75%</td><td>80%</td><td>85%</td></tr>
</table>
<table>
<tr><th>Mcf/ d | $/ mbtu</th><th>P <3.5</th><th>3.5 < P < 4.5</th><th>4.5 < P < 5.5</th><th>P > 5.5</th></tr>
<tr><td>First 25k</td><td>45%</td><td>50%</td><td>55%</td><td>60%</td></tr>
<tr><td>25k+ – 50k</td><td>50%</td><td>55%</td><td>60%</td><td>65%</td></tr>
<tr><td>50k+ – 100</td><td>55%</td><td>60%</td><td>65%</td><td>70%</td></tr>
<tr><td>100k+</td><td>60%</td><td>65%</td><td>70%</td><td>75%</td></tr>
</table></td><td>Profit sharing based on overall project’s profitability by way of measuring an R-factor.

R-factor formula: Cumulative Contractor’s (Cost Oil + Cost Gas + Profit Oil + Profit Gas) / Cumulative Contractor’s (CAPEX + OPEX)

Rates (Somali share):
▸20% for R≤ 1.0
▸Linear R-factor for 1.0 ‹ R ‹ 2.0
▸85% for R ≥ 2.0</td></tr>
</table>

Summary of existing & updated fiscal terms (Cont')

Fiscal feature	Current fiscal terms (Model PSA)	Proposed new fiscal terms
Specific oil and gas fiscal terms		
Special/other resource taxes	Fixed and detailed (Local Community Benefit). Recoverable: yes This feature effectively acts as a surcharge to the profit split. $500k per year until production start; thereafter a percentage of the contractor's Profit oil/gas, linked to oil ($/bbl) or gas price ($/mmbtu) - (P)	Annual Local Community contribution of US$ 200k annually until the start of production, US$500,000 annually thereafter. Cost-recoverable
	OIL 10%, for P < 35; 15%, for 35 < P < 45; 20%, for 45 < P < 55; and 25%, for P > 55. **GAS** 10%, for P < 3.5; 15%, for 3.5 < P < 4.5; 20%, for 4.5 < P < 5.5; and 25%, for P > 5.5.	Not applicable in the proposed framework
State participation	Detailed. The percentage is not fixed (only maximum is envisaged). Up to 40% from the start of development. No obligation to repay prior costs. The 40% could be split between a regional state company (1/3) and the federal state company (2/3).	Up to 25% anytime. Carried through exploration, full equity thereafter
Other: various fees	Contains a reference to the Fees envisaged in the 2008 Federal Petroleum Law. Recoverable: no	Removed
Common taxes		
Corporate income tax (CIT)	Not addressed, other than it is not cost recoverable	"Tax paid PSA" with nominal rate is 35%. Tax credit certificate available. For subcontractor - 5% withholding tax for non-resident and 3% for resident Capital gains are actually taxed at 20% rate
Interaction with taxes/levies that may apply or be established outside of the Model PSA or the 2008 Federal Petroleum Law	Not addressed with respect to potential issues once the contract is signed (whether anything outside of the Model PSA/2008 Federal Petroleum Law applies to an investor), i.e. on Effective Date.	Exemption
Imports/export duties	Exemption is envisaged	Exemption
VAT or alike taxes	Not directly addressed, expressly excluded from the definition of a tax	Exemption
Other general taxes (e.g., property tax, taxes levied by regions)	Not addressed.	Exemption

Royalty

Royalty helps to achieve minimum government take, however, it is important to keep in mind that it has a regressive nature.

Recommendation

- It is in the interest of Somalia to promote gas projects, thus setting lower rates for gas is reasonable
- The Consultant recommends relatively low gross royalties with differentiated rates of 5% for natural gas and 10% for crude oil and condensates.
- The 10%/5% rates can be further reduced depending on the country's needs and economic circumstances

Comparative assessment

Royalty	Oil	Gas
Somalia (proposal)	10%	5%
Kenya	None	None
Mozambique	10%	6%
Tanzania	12.5% for onshore and shelf up to 500m depth 7.5% for deepwater (deeper than 500m)	

Cost recovery

Recommendation

- The Consultant recommends the cost recovery limit of 70% of available petroleum (production less royalties), not distinguished for logistical environments (onshore, shallow water, deep water) or hydrocarbons type (natural gas or crude oil).
- Cost recovery for Somalia is proposed to be ring fenced to the contract area
- Within the cost recovery limit of 70%, the proposed cost recovery rules include 100% write off for all categories of expenditure, except for non-recoverable items, namely royalties, signature bonus, financial costs.
- Any unrecovered costs should be carried forward without limitations, subject to the contract's duration. Overall the accounting procedure as provided in the Model PSA is compliant with best practice in terms of accounting procedure in a PSA environment, but we would recommend inserting additional types of cost in the list of non-recoverable costs (Article 2.7 of the AP - Ineligible costs) as follows:
  - signature bonus;
  - foreign overhead costs that exceed 1% of total recoverable costs.

Cost recovery (Cont')

Comparative assessment

- Based on the comparative assessment, the recommended cost recovery limit is higher than those of Somalia's benchmark countries. Cost limit should not be assessed on a standalone basis and need to be considered in conjunction with the profit sharing rules, royalties and other fiscal features. We therefore consider the proposed cost recovery rules optimal given the nature of petroleum opportunities in Somalia and Somalia's frontier status.

Cost limit	Oil	Gas
Somalia (proposal)	70%. No distinction for oil and gas. Net of royalty. Signature bonus should be clearly excluded from being cost recoverable and foreign overhead costs in excess 1% of total recoverable costs as well.	
Kenya	60% of gross production since royalties do not apply. No distinction for oil and gas. Development costs should be depreciated over 5 years straight line (i.e. 20% each year over 5 years). A 15% uplift is applicable to development costs incurred in first 5 years from the approval of development plan. Interest, arrangement costs and any foreign exchange costs relating to loans or other financing arrangements raised by the contractor for capital expenditure in upstream petroleum operations under the contract are not recoverable. Allocation and recovery of overhead costs should be approved by the tax authorities.	
Mozambique	60%. No distinction for oil and gas. Net of royalty. Exploration and development costs are depreciated over 4 years straight line (i.e. 25% each year over 4 years), other costs are recovered at 100% rate.	
Tanzania	50%. No distinction for oil and gas. Net of royalty. Interest and financial charges are not recoverable. Foreign overhead costs are limited to 1% of total costs.	

Production sharing

Recommendation

- The Consultant recommends linking the profit sharing to the R-factor sliding scale.
- The proposed ***R-factor formula*** is the cumulative gross total revenue after royalties divided by the total project's costs:

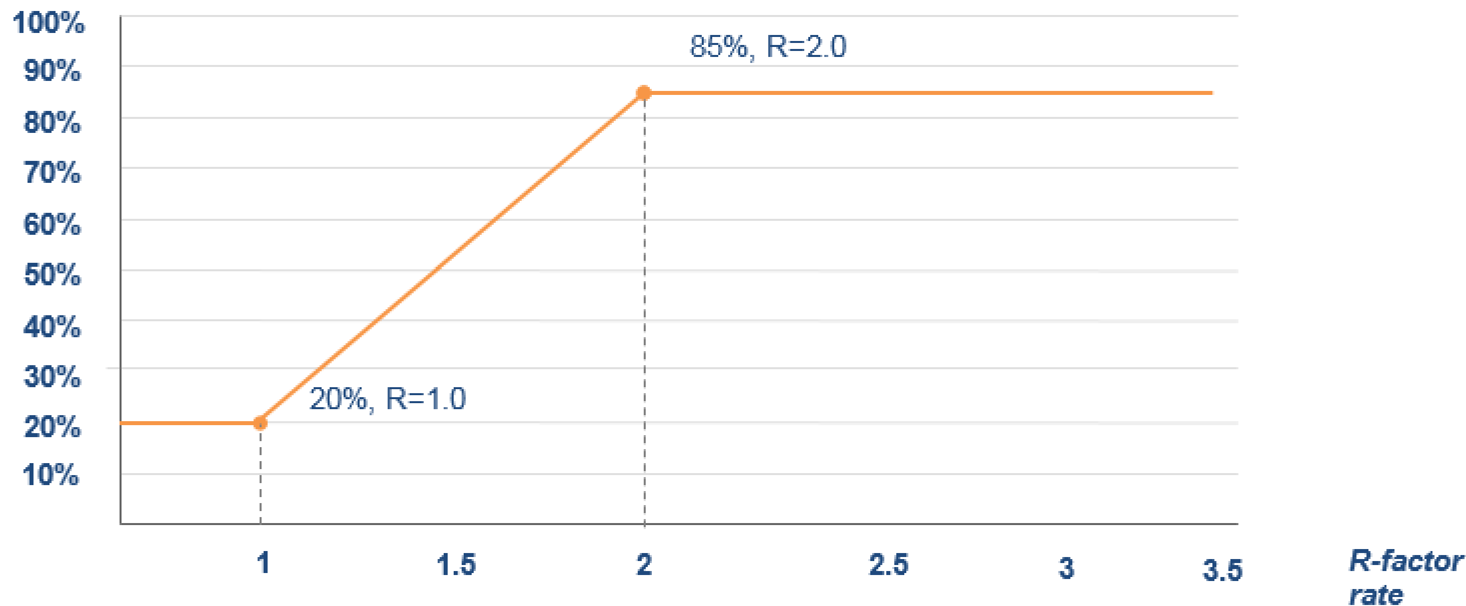
$$\frac{\textit{Cumulative Contractor's (Cost Oil + Cost Gas + Profit Oil + Profit Gas)}}{\textit{Cumulative Contractor's (CAPEX + OPEX)}}$$

- This proposed formula is based on the notion that it is a transparent and easy-to-administer production sharing formula.
- It also helps mitigate any potential controversy surrounding the classification of expenditure as operating expenditure (OPEX) or as capital expenditure (CAPEX) as both form the denominator.
- The PSA should specify whether the costs are measured on the same basis as costs allowable for cost recovery (e.g., treatment of interest and overheads).

Production sharing (cont')

Recommended threshold structure (Public Authority's share)

- **20%,** for R- factor less than 1.0
- Linear between R-factor of 1.0 (20% rate) and 2.0 (85% rate): 20%+(R-1.0)/(2.0-1.5)*(85%-20%)
- **85%,** for R-factor of 2.0



Production sharing (cont')

Comparative assessment

Profit sharing	Oil	Gas
Somalia (proposal)	20%, for R- factor less than 1.0 Linear between R-factor of 1.0 (20% rate) and 2.0 (85% rate) 85%, for R-factor of 2.0 **Cumulative Contractor [Cost Oil + Cost Gas + Profit Oil + Profit Gas] / Cumulative Contractor [CAPEX + OPEX]**	
Kenya	Profit sharing basis: R-factor. No distinction for oil/gas and onshore/offshore. State's share: 50%: R < 1 65%: 1 < R < 2.5 75%: R ≥ 2.5 **Cumulative [Cost petroleum + Profit petroleum – Production costs – Decommissioning costs] / Cumulative [Exploration costs + Development costs]**	
Mozambique	Profit sharing basis: R-factor. No distinction for oil/gas and onshore/offshore. State's share: 15%: R < 1 25%: 1 < R < 1.5 35%: 1,5 < R < 2 50%: 2 < R < 2.5 60%: R ≥ 2.5 **Cumulative [Concessionaire's Share of profit-petroleum + Concessionaire's Cost Petroleum - Operating Costs] / Cumulative [Exploration costs + Development costs + production costs]**	

Production sharing (cont’)

Comparative assessment

Profit sharing	Oil	Gas
Tanzania	Profit sharing basis: **daily production** Profit sharing basis: daily production. Rates are distinguished for oil/gas as well as for onshore/offshore. State’s share provided below (the rates for oil have been decreased in the end of 2015 compared to the rates reflected in the Inception report)	
	Oil onshore and shelf (<500m) 50%: kbopd < 12.5 55%: 12.5 < kbopd < 25 60%: 25 < kbopd < 50 65%: 50 < kbopd < 100 70%: kbopd > 100 Oil deepwater (>500m) 50%: kbopd < 50 55%: 50 < kbopd < 100 60%: 100 < kbopd < 150 65%: 150 < kbopd < 200 70%: kbopd > 200	Gas onshore and shelf (<500m) 60%: mmcfd < 20 65%: 20 < mmcfd < 40 70%: 40 < mmcfd < 60 75%: 60 < mmcfd < 80 80%: mmcfd > 80 Gas deepwater (<500m) 60%: mmcfd < 150 65%: 150 < mmcfd < 300 70%: 300 < mmcfd < 450 75%: 450 < mmcfd < 600 80%: 600 < mmcfd < 750 85%: mmcfd > 750

1 2 3

Corporate income tax

Recommendation

- The Consultant recommends that corporate income tax will apply to the petroleum operations, but in a way that may be suitable for Somalia at its current state of general fiscal framework – to be factored into the public authority's share of profit share of production (a "tax paid" contract).

Comparative assessment

- Based on the comparative assessment, the proposed corporate income tax structure is different from the peer group. However, we consider the proposed approach reasonable in order to simplify the overall fiscal framework and envisage the basic income tax provision in Somalia.

CIT	
Somalia (proposal)	Contractor is subject to income tax, although the tax is not effectively levied but included into the public authority's share of profit oil. Tax rate: 35%
Kenya	Contractor is subject to income tax laws. Tax rate: 30%
Mozambique	Contractor is subject to income tax laws. Tax rate: 32%
Tanzania	Contractor is subject to income tax laws. Tax rate: 30% In addition to corporate income tax a contractor pays a net cash flow tax linked to the rate of return. The tax rate is 25% once rate of return of 20% is achieved.

Signature bonus

Recommendation

- The Consultant recommends including a signature bonus only. Production bonuses are not proposed due to their negative attributes from an investor's standpoint.
- The signature bonus is proposed to be biddable with a pre-set minimum of US$ 200,000. The signature bonus should be non-recoverable for cost recovery purposes.
- We propose the contract awarding criteria to be an incremental work program (in addition to the pre-set minimum work program for each block), and the signature bonus. For bid evaluation purposes, we propose to set the evaluation mark at 25% for the signature bonus, and at 75% for the incremental work program. The greater mark for the incremental work program is explained by the greater need for Somalia to obtain as much geological data and have as many exploration wells drilled as possible.

Comparative assessment

- Based on the comparative assessment, the recommended bonus structure is moderate; however this does not represent negative consequences for Somalia considering its objective to attract investors. The proposed structure envisages a biddable nature of the signature bonus creating market conditions for blocks awards.

Bonuses	
Somalia (proposal)	Signature bonus: Biddable with a pre-set minimum of US$ 200,000. Production bonus: None.
Kenya	Signature bonus: Biddable/negotiable. Production bonus: None.
Mozambique	Signature bonus: None. Production bonus: Biddable/negotiable.
Tanzania	Signature bonus: US$ 2,500,000. Production bonus: US$ 5,000,000.

Surface rentals

Recommendation

- The Consultant recommends that the surface rental rates should be set based on the acreage of blocks. The current average block's acreage in Somalia is relatively large.
- Considering the average acreage, we propose the rental rates to stay the same as they are currently envisaged in the existing Model PSA: US$10 per square kilometer during the exploration phase and US$100 per square kilometer during the development and production phase.
- Rentals are recommended to be cost-recoverable.

Comparative assessment

- Based on the comparative assessment, the recommended rentals are in line with those of Somalia's peer countries. The recovery treatment of rentals in the peer group is rather unusual under a broader international perspective. Usually surface rentals are recoverable, therefore we recommend to keep the surface rentals cost-recoverable.

Surface rentals	
Somalia (proposal)	US$10 per square kilometer during the exploration phase and US$100 per square kilometer during the development and production phase. Cost-recoverable.
Kenya	Surface rentals are biddable. Typically are at the level of US$100 per square kilometer for development stage. Surface rentals are non-recoverable
Mozambique	None
Tanzania	Initial exploration period - US$50 per square kilometer. First extension period - US$100 per square kilometer. Second extension period - U$200 per square kilometer. Annual license charge for a development license: US$500 per square kilometer. Surface rentals are non-recoverable.

Training contributions

Recommendation

- The Consultant recommends keeping the training contribution of US$200,000 annually, with the contribution being recoverable, as envisaged in the current Model PSA. The training fees should represent the budget for training and educational program(s) and be included in the annual project's work program or budget of the investor, rather than a payment that is made to a designated country's institution

Comparative assessment

- Based on the comparative assessment below, the recommended level training fee is in line with those of Somalia's neighboring countries.

Training contributions	
Somalia (proposal)	US$ 200,000 annually. Cost-recoverable.
Kenya	Biddable/Negotiable. Payable during exploration and development phase. Cost-recoverable.
Mozambique	Biddable/Negotiable. Annual contributions to the Ministry of Energy training fund.
Tanzania	US$500,000 annually. Cost-recoverable

Local community contributions

Recommendation

- The Consultant recommends keeping the local community contribution but switching from a percentage formula to a lump sum mechanism. We would suggest setting it at US$ 200,000, payable on an annual basis until the start of production, then increasing the annual contribution up to US$ 500,000.
- This payment should be recoverable for cost oil purposes. This local community payment is a modified version of the local community benefit included in the Model PSA, but is set at a much lower level.

Comparative assessment

- Based on the comparative assessment, we have not identified similar payments to compare. This payment is aimed at addressing the particular federal issue relevant to Somalia, therefore the peer group's frameworks have little relevance in this respect.

Training contributions	
Somalia (proposal)	US$200,000 annually until the start of production, US$500,000 annually thereafter. Cost-recoverable.
Kenya	We have not identified similar payments which aim is to allocate portion of the rent to local communities.
Mozambique	
Tanzania	

Government participation

Recommendation

- The Consultant recommends retaining the option for Somalia for direct participation in projects, through a single competent entity, and propose that the maximum interest that such competent authority may have is set to 25%.
- We also particularly stress that although the option for a public direct participation is retained, we recommend that the competent entity does not execute its right due to financial obligations that it would impose on such competent entity (and apparently on Somalia), and other considerations, such as insufficient capacity of the competent entity, potential for political interference and possible costly delays on the part of the competent entity in meeting cash calls which will have negative impact on investors.
- We propose that the competent entity be granted the ability to utilize its option within 6 months from the approval of a development plan.
- We also propose that the competent entity's interest is carried through exploration (in other words, Somalia would not reimburse investor(s) for its percentage of exploration costs), and becomes full equity interest thereafter (in other words, Somalia will contribute 100% of its share of costs after the exploration phase is completed). Since Somalia would most likely join a project only after a commercial discovery is made (if any), it would seem reasonable from an investor's perspective that Somalia would need to contribute to any post-exploration costs. It is important to note that the development phase would be the most capital-intensive phase of a project since the majority of production and drilling of injection wells will be done to ramp up the hydrocarbons production.

Government participation (cont')

Comparative assessment

- Based on the comparative assessment, the recommended maximum participation percentage is in line with the peer group.

Training contributions	
Somalia (proposal)	Maximum participation share of 25%. Exploration costs, including appraisal, are not reimbursed.
Kenya	Biddable/negotiable. Participation starting development stage. Exploration costs are not reimbursed.
Mozambique	Biddable/negotiable. Carried though exploration stage but repayable with interest later. Interest in the 5th licensing round was 10%, 15%, 20% and 30%.
Tanzania	Minimum 25% at any time. Exploration costs, including appraisal, are not reimbursed.

Taxation of capital gains

Recommendation

- The Consultant recommends that Somalia opts to tax capital gains arising from transactions where the value is derived by its natural resources, whether through a direct or indirect transfer of interest.
- The recommendation is to target only those capital gains which will result from cash payments.
- We propose the capital gains tax rate to be 20% on the difference between a sale price (immediate component only) and a purchase price (i.e. historical costs).
- In order for the public authority to identify that a transfer of interest has occurred, including intercompany reorganizations, we propose that change of controls procedures are implemented to monitor any change of control, and thus any transfers of interest.
- We recommend introducing an annual filing template to report capital gains to emphasize the existence of capital gain taxation and companies' awareness. We recommend that in case of absence of taxable events for capital gain purposes, a nil return is still filed by a company to emphasize the responsibility of companies' officers and maintain tax discipline.

Taxation of capital gains (cont')

Comparative assessment

- Based on the comparative assessment below, the proposed capital gains tax is in line with the capital gains tax imposed by Somalia's neighboring countries.

Capital gain tax	
Somalia (proposal)	Both direct and indirect sales are captured. Tax rate: 20%, applicable to the difference between the petroleum costs (recoverable and non-recoverable) incurred by the assignor and the total acquisition price (immediate proceeds only)to be paid by the assignee.
Kenya	Both direct and indirect sales are captured. The rate is 20% for non-residents and 10% for residents. A licensee or contractor is required to notify the Commissioner immediately in case of change in the underlying ownership of a licensee or contractor of 10% or more. Where the interest is disposed by a nonresident, the licensee or contractor shall be liable, as the tax agent of the nonresident person, for tax payable as a result of the disposal.
Mozambique	Both direct and indirect sales are captured. The rate is 32%. Nonresidents must appoint a tax representative in Mozambique to comply with their tax obligations. The purchaser or the holder of the petroleum rights has joint and several responsibility for the payment of the tax in case the seller is a nonresident entity without permanent establishment in Mozambique. In the case of resident taxpayers, the gain is included in the taxable income of the respective financial year and is taxed at a general rate of 32%.
Tanzania	Both direct and indirect sales are captured. Where the underlying ownership of an entity changes by more than 50% as compared with the ownership at any time during the previous two years, the entity is treated as realizing any assets owned and any liabilities owed by it immediately before the change. Intercompany reorganizations are not exempt. The rate is 30%. Additional stamp duty applies.

Customs duties

Recommendation

- The Consultant we assumed there is no existing customs duties legislation in Somalia. In order to make it simpler to administer (as opposed to drafting a new legislation on such complex matter), we recommend exempting petroleum operations from customs duties, both from import and export duties.
- This is generally in line with international practices applied to upstream projects by many governments. The recommendation is to provide the exemption throughout the project's life for fiscal stability and predictability purposes. From the revenue stream perspective for Somalia, revenue will be generated from other fiscal features, should there be commercial discoveries in Somalia.

Comparative assessment

- Based on the comparative assessment below, the recommended approach is in line with those of Somalia's neighboring countries. The recommendation for full exemption for Somalia is explained as it will be easier to administer.

Customs duties	
Somalia (proposal)	Exemption
Kenya	Exemptions apply to companies engaged in the exploration and prospecting of oil and gas for machinery and other items necessary for the oil and gas business.
Mozambique	Exemption or a period of five years from the date a development plan is approved.
Tanzania	Exemption

Taxation of subcontractors

- The considerations for taxing subcontractors in Somalia are challenging. Due to the absence of established petroleum industry in Somalia, and lack of local oil field service companies, contractors will need to involve foreign subcontractors which will account for almost all of the project's capital expenditures. Clearly sub-contractors will be receiving revenue emanating from Somalia which are expected to be taxed in Somalia.
- On the other hand, subcontractors also have gross up clauses on their contracts to ensure that no withholding taxes (as may be applicable) reduce their remuneration for a service or equipment. If a withholding tax will apply in Somalia, (say a 10% tax), that will effectively mean that project's costs will become more expensive by 10% since the withholding tax will need to be compensated by contractor at its own costs. Therefore, taxing subcontractors at this stage of sector in Somalia is a challenging policy issue.
- As for the local subcontractor, due to the absence of corporate income tax in Somalia, it seems reasonable to introduce a withholding tax, which will be withheld by a contractor.

Recommendation

- The Consultant recommends that a withholding tax is introduced at moderate levels with the separate rates for foreign and local subcontractors. The rate for foreign subcontractors is recommended to be 5%, and a 3% rate for local subcontractors with reasonable substance in Somalia (for example, set up a warehouse and bring its technical and administrative specialists on-shore) to create an incentive for service companies to set up a legal presence in-country.

Taxation of subcontractors (cont')

Comparative assessment

- Based on the comparative assessment below, the recommended approach is in line with those of Somalia's neighboring countries. The proposed tax rates for Somalia may be considered lower than in the benchmark countries, but the frontier status of Somalia needs to be taken into consideration to reduce distortions for potential investors for the first licensing round.

Taxation of subcontractors	
Somalia (proposal)	5% withholding tax for non-resident and 3% for local providers.
Kenya	Effective 1 January 2016, withholding tax on fees paid to a non-resident subcontractor in respect of services relating to petroleum operations reduced from 20% to 5.625%.
Mozambique	10% withholding tax.
Tanzania	Payments to non-residents for services related with the petroleum activity are subject to withholding tax at the rate of 15%. A 5% rate applies to resident providers.

Withholding tax on dividends and loans

Recommendation

- The financing of upstream projects will be coming mostly from intragroup companies, therefore, the Consultant recommends an exemption on withholding tax applied to loan interest, since the interest is not cost recoverable and the contractor will not take advantages of any tax deductions. From revenue stream perspective for Somalia, revenue will be obtained from other fiscal features, should there be commercial hydrocarbon discoveries in Somalia. Once Somalia will have an established general corporate income tax framework, applicable to all industries, a withholding tax may be introduced to target third party financing.
- As for the dividends a 10% withholding tax rate may be considered.

Comparative assessment

- Based on the comparative assessment below, the recommended approach differs from the peer group. The recommendation for full exemption for Somalia is explained by easier administration and the need to remove distortion for operators for the first licensing round, since the tax on loans will effectively increase operator costs. The exemption of dividends could create an incentive to finance the project through equity rather than loans.

Withholding tax on dividends and loans	
Somalia (proposal)	Dividends: 10%. Loans: exemption
Kenya	Dividends: 10%. Loans: 15%.
Mozambique	Dividends: 20%. Loans: 20%.
Tanzania	Dividends: 5% or 10%. Loans: 10%.

Personal income tax and social payments

Recommendation

- The Consultant assumed there is no existing comprehensive legislation in Somalia on these matters. In order to make it simpler to administer (as opposed to drafting a new legislation on such complex matter), we propose that a full exemption on the Employer portion of personal income tax and/or social payments is granted to employees involved in petroleum operations (i.e. the employee will still be subject to such taxes individually).
- From the revenue stream perspective for Somalia, revenue will be obtained from other fiscal features, should there be commercial hydrocarbon discoveries in Somalia.

Comparative assessment

- Based on the comparative assessment below, the recommended approach differs from the peer group. Considering the absence relevant legislation in place in Somalia, the recommended approach will be easier from an administration management perspective.

Personal income tax and social payments	
Somalia (proposal)	Exemption
Kenya	Personal income tax: 10%-30% Social payments: KES 200 per month
Mozambique	Personal income tax: 32% Social payments: 7% Non-residents are taxable only on their Mozambican source income at 20%.
Tanzania	Personal income tax: 12%-30% Social payments: 20%

Analysis of the attractiveness and competitiveness of the new fiscal terms

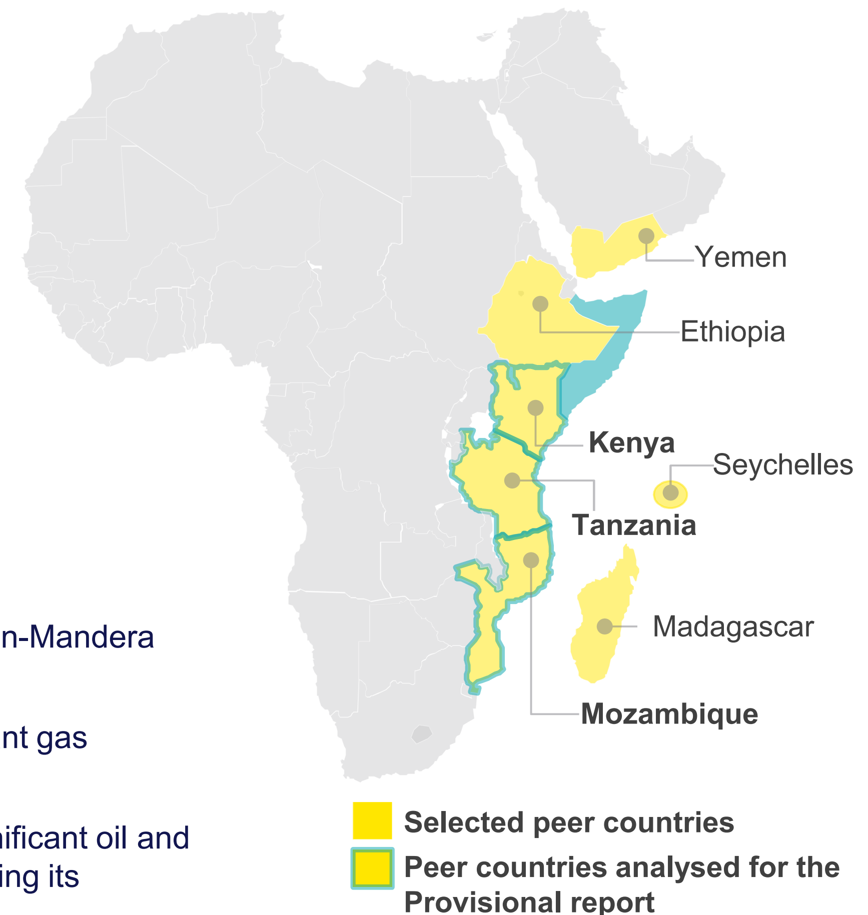
Introduction to the comparative analysis of fiscal terms

- The aim of Somalian government is to promote the opportunities in the petroleum sector of Somalia and therefore attract international companies' interest and subsequently investments. As far as the fiscal framework is concerned, it will be essential for Somali to provide competitive fiscal environment for potential investors that would be making a choice of investing in Somalian petroleum opportunities or in petroleum opportunities elsewhere.

- For the purpose of comparative assessments for each fiscal term below, we have selected the three countries, being Kenya, Mozambique and Tanzania, as the countries that are most active in petroleum activities in the peer group of countries that were analyzed in the Inception Report.

Benchmark countries:

- **Kenya**: shares the Lamu Embayment basin and the Somali-Ogaden-Mandera Lugh basin together with Somalia
- **Tanzania**: a relative neighboring country in the region with significant gas opportunities and expected LNG projects.
- **Mozambique**: a relative neighboring country in the region with significant oil and gas opportunities and expected LNG projects. Proactive in promoting its petroleum opportunities.



Government take concept and IRR

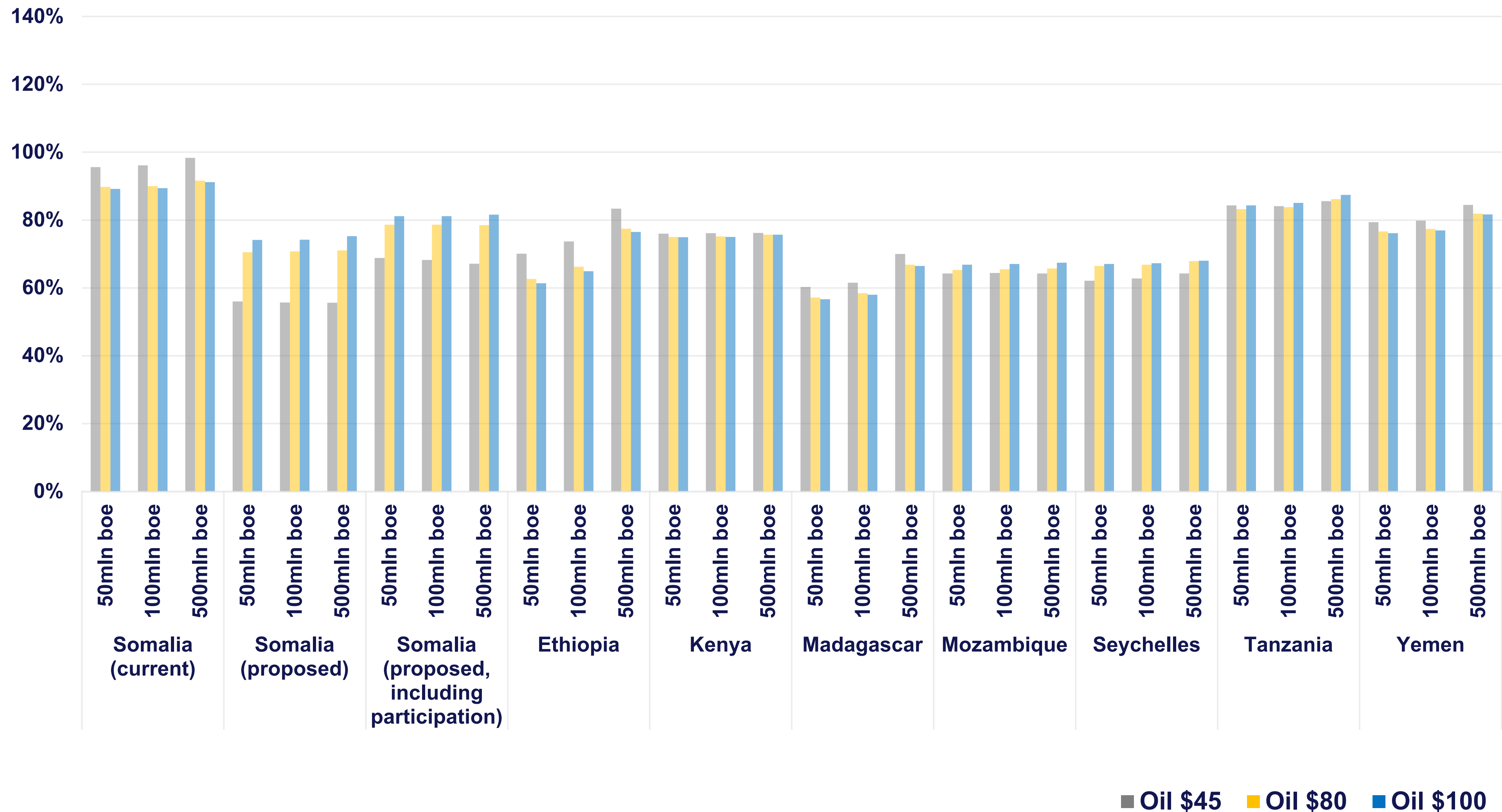
Government take

$$\text{Government take, \%} = \frac{\text{All payments to government over project's life}}{\text{Pre-tax NCF: Project's revenue - CAPEX - OPEX}}$$

Internal rate of return (IRR)

- The rate of return indicates the profitability of an investment. The rate of return is a measure of earning power. The IRR however does not provide insight into the size of the profits.
- IRR is a relatively practical measurement of project's economics from investor's standpoint. However, it should always need to be considered in conjunction with other economic yardsticks, such as net present value and others. A minimal acceptable IRR may significantly vary for companies, depending on their strategies and profile. An average minimal acceptable IRR in the industry may be considered in the range of 15% to 20%.

Assessment of government take



Assessment of government take

Government take (10% discounted)

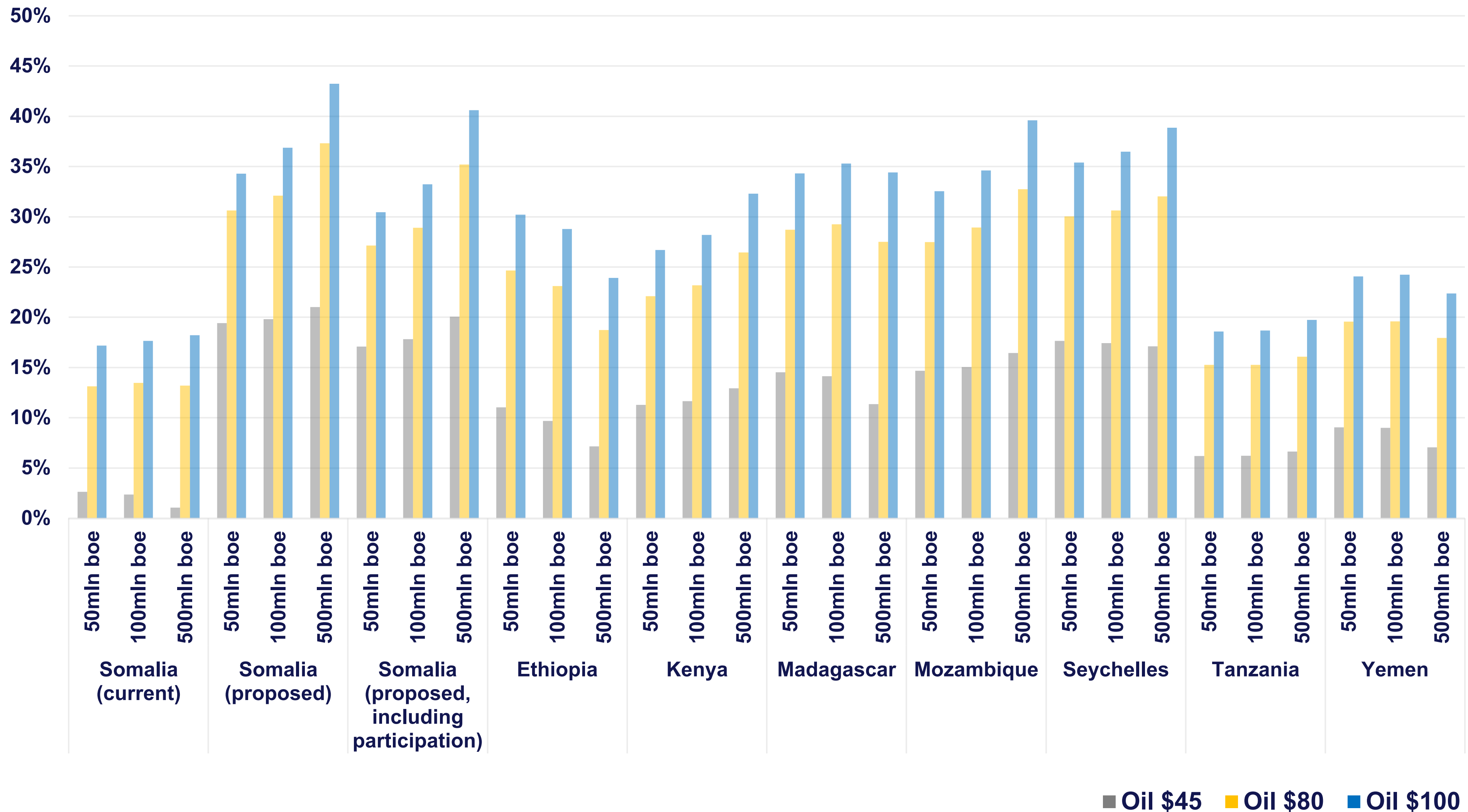
140%
120%
100%
80%
60%
40%
20%
0%

50mln boe 100mln boe 500mln boe (repeated for each country)

Somalia (current)
Somalia (proposed)
Somalia (proposed, including participation)
Ethiopia
Kenya
Madagascar
Mozambique
Seychelles
Tanzania
Yemen

Oil $45 Oil $80 Oil $100

Assessment of IRR



Building a better working world

- **Mathieu Calame**
  Director, Tax
  tel. +225 20 30 60 54
  mathieu.calame@ci.ey.com

- **Emma Cotton**
  Director, Valuation and Business Modelling
  tel. +44 207 951 4194
  ecotton@uk.ey.com

- **Alexey Kovshin**
  Manager, Tax
  tel. +971 56 507 00 62
  alexey.kovshin@ae.ey.com