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East Africa's tax and regulatory regime

Does it enhance the bankability of the region's power projects

East African Power Industry Convention

26 August 2015

1. Outline

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2. Profile of facilitator

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Denis is a Senior Tax Manager in Deloitte East Africa. He is based in Nairobi, Kenya. He is a UK trained energy and investment professional. He is a Certified Chartered Accountant and a Certified Public Accountant of Uganda. He holds a Bachelor’s Degree in Law, a Post Graduate Diploma in Legal Practice and a Master’s Degree in Law in Petroleum Taxation and Finance from the Centre for Energy, Petroleum, Mineral Law and Policy at the University of Dundee in United Kingdom. He has worked in Uganda, Kenya and Tanzania.

He possesses technical expertise in downstream energy law and policy and thus familiar with issues pertaining power sector reforms in developing countries, energy regulation, power contracting including negotiating and structuring Power Purchase Agreements. He has also written an academic paper appraising the nascent East African Power Pool. He is conversant with the financial appraisal of energy projects, project financing of electricity projects as well as the investment protection of large capital projects within the framework of international investment law.

He also has an excellent understanding of petroleum law, policy and economics, mineral law, policy and economics, mineral and petroleum taxation as well as international legal and policy framework for project finance.

3. Abbreviations

BITs: Bilateral Investment Treaties;

CIF: Cost, Insurance and Freight;

CIT: Corporate Income Tax;

DTA: Double Tax Agreement;

EACCMA: East African Community Customs Management Act, 2004;

EAPP: East African Power Pool;

ERA: Electricity Regulatory Authority;

ERC: Electricity Regulatory Commission;

EWURA: Energy Water and Utilities Regulatory Authority;

ITA: Income Tax Act;

IPPs: Independent Power Producers;

Abbreviations

KENGEN: Kenya Electricity Generating Company Limited;

KPLC: Kenya Power and Lighting Company Limited;

KETRACO: Kenya Electricity Transmission Company Limited;

NSE: Nairobi Stock Exchange;

PPAs: Power Purchase Agreements;

TANESCO: Tanzania Electric Supply Company Limited;

WHT: Withholding tax;

UEGCL: Uganda Electricity Generating Company Limited;

UETCL: Uganda Electricity Transmission Company Limited;

VATA :Value Added Tax Act.

4. Overview of power sector reforms

- Liberalization, unbundling of the sector and privatization are key features of East Africa's power sector reforms. The reforms notwithstanding, energy policy formulation remains the responsibility of the government.
- The electricity industry from generation to transmission and distribution was under the complete ownership and control of governments. Power companies were not only vertically integrated but were also state owned. There were however exceptions notably in the United States and Germany.
- Private sector participation in the electricity sector generally began in the late 1980's with the introduction of competition but gathered momentum in East Africa in the late 1990's.
- Power sector reforms were driven by a number of reasons but it is noteworthy not to ignore the geopolitical landscape notably the collapse of the Former Soviet Union and the triumph of capitalism. Margaret Thatcher and Ronald Reagan days!
- Liberalization of the power sector does not start from a blank piece of paper but rather makes use of the existing facilities. New generating plant is not built instantly and new wires also take time to construct.

Overview of power sector reforms

- Electricity systems are liberalized for different reasons but these can be put into two distinct categories. The first is those systems which have sufficient capacity to meet demand, meaning that liberalization is carried out to create competition between existing facilities in an effort to bring down the price (or at least minimize price rises).
- The second category presents far greater difficulty – it is those systems which have insufficient capacity to meet demand. Numerically this second category is larger than the first, and typically presents a fundamental difficulty.
- The basic reason to liberalize countries in the second category is to provide additional access to funds for investment. Many countries in this category simply cannot afford to build new plant and infrastructure, and are effectively forced to undertake a degree of liberalization to permit (foreign) companies to build new plant.
- Liberalization of this category presents greater challenges as it is far from certain that the act of liberalization will lead to lower prices – indeed it may precipitate higher prices to pay for new plant.
- Contracts to secure investment can also make it difficult to develop competition between generators.(The operation of PPAs)

Overview of power sector reforms

- This difficulty is often complicated by there being a subsidy on the existing consumer price. Taking out that subsidy – as strongly encouraged by the World Bank – can lead to significant price rises. Liberalization has therefore attracted considerable political opposition in most countries.
- Liberalization is the removal of a monopoly right and the introduction of competition and choice. In the case of electricity, there are is a massive range of options with respect to liberalization. Full liberalization involves an understanding of each sector of the industry. The electricity industry can be divided into five separate sectors.

Sector	Discussion
Generation	The creation / manufacture of electricity using any fuel source (including renewables).
Transmission	Long distance transfer of electricity at high voltage. Wires are a natural monopoly.

Overview of power sector reforms

Sector	Discussion
Distribution	Local transfer of electricity at low voltage. The last part of the wire network into the consumption point. Also a natural monopoly
Supply	The activity of arranging for a consumer to receive a quantity of electricity, and the wholesale purchase of that quantity. Supply also involves the billing of the consumer
Metering	Not always regarded as a separate function as in practice it may be part of the supply function. Metering is the activity of establishing the quantity of electricity used. The function can be entirely separate from supply depending on ownership of the meter.

5. Scale of East African power sector reforms

Issue	Kenya	Uganda	Tanzania
Liberalization	Possible to participate in all sectors of the power industry (limits of monopoly)	Possible to participate in all sectors of the power industry (limits of monopoly)	Possible to participate in all sectors of the power industry (limits of monopoly)
Unbundling	Yes IPPs KENGEN KETRACO KPLC	Yes IPPs UEGCL UETCL UEDCL	Envisioned IPPs TANESCO
Privatization	Partial government ownership KENGEN and KPLC partially listed on the NSE	Concession arrangement ESKOM UMEME	Not yet

5. Bankability of power projects

- Bankability simply refers to the ability to raise finance to support a project. Private investment in the power sector comes in one of these three distinct forms set out below
- Refinancing of existing assets through sale or securitization: Outright sale to the granting of the concession without transfer of ownership. The case of Uganda.
- Upgrading or rehabilitation of existing assets: ROM which is rehabilitate, operate and maintain under which the concessionaire has the right to operate the scheme and sell its production for a specified period. The case of Uganda
- Construction of new greenfield projects

Bankability of power sector

The issues in power financing

- Majorly premises on project financing. Export Credit Agencies, Multi lateral development Agencies, Commercial banks, Bonds issue
- Project definition: The cost and level of front end studies to undertake prior to committing to a project. 2% to 3% of total project costs
- Completion risks
- Constructions risks
- Hydrological risks
- Volume and market risks
- Regulatory risks: Taxation, security of tenure, awarding of the concession, pricing of the power
- Capital intensiveness of a project
- Environmental risks

6. Tax and legal regime and the bankability of E.A's power sector

A. Liberalization of the power sector

Uganda, Kenya and Tanzania have liberalized the electricity sector pursuant to the provisions of their respective Acts. Private investors may participate in the various sectors of the power sector subject to having a license in place

Issue	Kenya	Uganda	Tanzania
Provisions of the Electricity Act or Energy Act	Generation license Transmission license Distribution license	Generation license Transmission license Distribution license	Generation license Transmission license Distribution license

Tax and legal regime and bankability of E.A's power sector

B. Transferability of license

Uganda, Kenya and Tanzania permit the transferability of licenses subject to approval by the independent regulator. Eases the securitization of project financing

Tax and legal regime and bankability of E.A's power sector

C. Independent Power Regulator

- The aim of regulation is simply to help achieve the aims of the liberalization programme. Liberalization generally aims to create competition with a view to lowering prices to consumers – or at least minimizing price rises.
- There is a strong possibility that in a country which is capacity short, liberalization to attract investment will lead to higher prices particularly where the liberalization programme is accompanied by a reduction or removal of consumer subsidies
- Regulatory capture: Regulatory capture occurs where a regulator makes decisions which are not truly his own, but instead are unduly influenced by another party
  - *Surrogate of the Minister*
  - *Information asymmetry resulting into the second guessing of costs*
  - *Financing of regulator operations*
  - *Appointment process of the members of the regulator*

Tax and legal regime and bankability of E.A's power sector

- Private investment in the power sector among other factors will be attracted to a country that is perceived to have an independent regulator. How independent is the regulator??

Uganda	Kenya	Tanzania
ERA	ERC	EWURA

Tax and legal regime and bankability of E.A's power sector

D. Investment protection

- Private investors seek assurance that the risk of unilateral and arbitrary changes to the law and investment agreements which can dilute the value of their project can be satisfactorily managed from the very outset
- Legislative protection: Legislative support against unilateral revision of petroleum terms is usually by substantive provisions in national legislation setting out guarantees for the protection of a category of investments
- Treaty based protection: Instruments such as bilateral and multilateral investment treaties are also used to protect investors. Bilateral Investment Treaties (BITs) concluded between capital exporting and importing countries set out substantive principles on investment protection as well as the procedures of investor state arbitration
- Stabilization clauses: Investors in the petroleum sector are keen to include in their investment agreements stabilization clauses. These clauses aim at ensuring that future changes in a country's legislation do not vary the terms of the contract as originally concluded
- The possibility of International arbitration

Types of stabilization clauses

Type of stabilization clause	Discussion
Prohibition on unilateral changes	They are also known as intangibility clauses. They ensure that the terms of the investment agreement are neither modified nor abrogated except with the contracting party's mutual consent.
Freezing clauses	The host state is precluded from changing its legislation in relation to the relevant project. Such clauses are criticized as encroaching on a country's sovereign legislative prerogative.
Allocation of burden	These clauses seek to allocate the fiscal and related burdens created by a unilateral change in the law usually to the NOC or the State.
Balancing clauses	These are sometimes called economic stabilization clauses. They provide for automatic adjustments or negotiations to restate the initial economic balance of the investment should there be an amendment to legislation with a fiscal impact to the investment.

Tax and legal regime and bankability of E.A's power sector

E. Foreign investment participation

The essence of liberalizing the power sector is to attract power investment. There are no restrictions in Kenya, Uganda and Tanzania with respect to participation of foreign investors in the power sector.

Tax and legal regime and bankability of E.A's power sector

F. Tax holidays or reduced tax rates

- *Generally no tax holidays or reduced tax rates except if the investment is undertaken under the EPZ tax regime which would likely not apply to electricity projects.*

Issue	Kenya	Tanzania	Uganda
CIT rate	30% for subsidiary 37.5% for branch	30% for both subsidiary and branch	30% for both subsidiary and branch
Branch Repatriation tax	Not applicable	10%	15%
Accelerated wear and tear	Available	Available	Not available
Dividends	WHT at the rate of 10% subject to DTA terms	WHT at the rate of 10% subject to DTA terms	WHT at the rate of 15% subject to DTA terms

Tax and legal regime and bankability of E.A's power sector

G. Profit repatriation

There are no restriction on profit repatriation in Uganda, Kenya and Tanzania

Tax and legal regime and bankability of E.A’s power sector

H. Value Added Tax regime

Issue	Kenya	Tanzania	Uganda
Position at construction phase	Inability to register for VAT Exemption from VAT on taxable supplies procured during the exploration and construction for power to the National Grid	Scope for registration as an intending trader Scope for VAT deferral	Inability to register for VAT Exemption from VAT for some supplies otherwise VAT applies
Position at production phase	Entitled to register for VAT Subject to VAT at the rate of 16%	Entitled to register for VAT Subject to VAT at the rate of 18%	Entitled to register for VAT Subject to VAT at the rate of 18% except solar power

Tax and legal regime and bankability of E.A's power sector

I. Import or customs duty regime

The East African region is a Customs Union with one applicable legislation. This is the East African Community Customs Management Act, EACCMA.

Most capital equipment will attract import duty at the rate of 0%

Machinery, spares and inputs for direct use in Geothermal exploration are exempted from import duties

Other items may potentially attract import duties at the rate of 10%, 25% or even higher rates

Destination inspection fees of the FOB value of items imported permanently

Import Declaration Fee of 2.25 of the CIF value of items imported permanently into Kenya

Railway Development Levy of 1.5 of the CIF value for goods imported permanently into Kenya. Similarly applies in Tanzania and Uganda

Tax and legal regime and bankability of E.A's power sector

J. Local government levies

Nominal except for Tanzania which has the City Service Levy computed as 0.3% of the company's turnover

Tax and legal regime and bankability of E.A's power sector

K. Local content

No local content requirements to employ or procure local products and materials during the construction phase of the project

Tax and legal regime and bankability of E.A's power sector

L. Feed in Tariff

- For the renewables

Tax and legal regime and bankability of E.A's power sector

M. The nascent East African Power Pool

- Can the EAPP be fully established in the current legal and tax environment?

Tax and legal regime and bankability of E.A's power sector

N. Withholding taxes on services payments

- Uganda
- Kenya
- Tanzania

Questions & Answers

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