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Overview of Extractives industry in Kenya

PAFA and ICPAK IFRS Conference

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Contents

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Oil & Gas Sector

Oil & Gas value chain

Upstream

Comprises exploration and production (E&P) of petroleum crude oil and natural gas.

Midstream

Involves storage and transportation from exploratory wells to storage terminals.

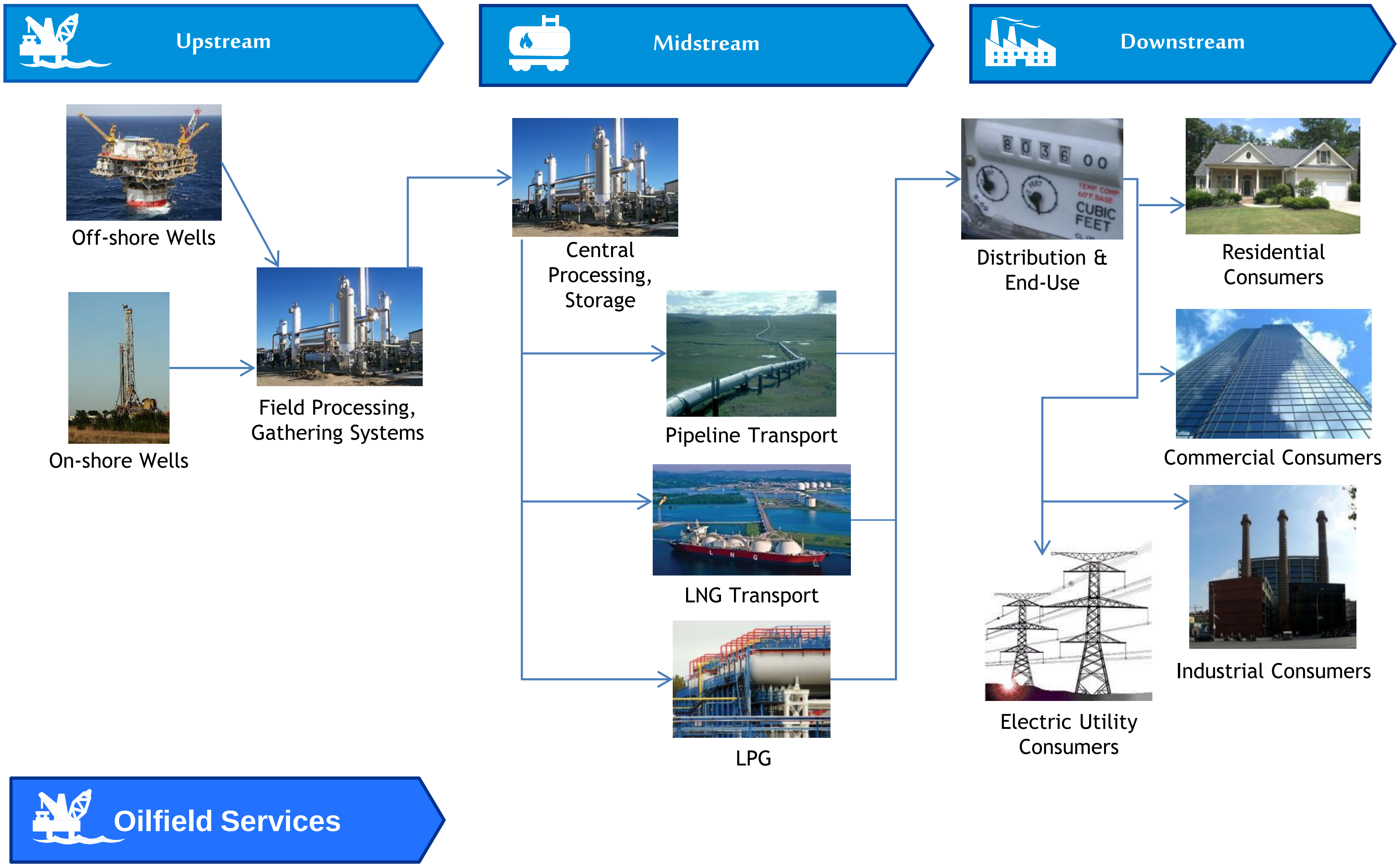
Downstream

Involves refining, processing and marketing, after the production phase, through to the point of sale.

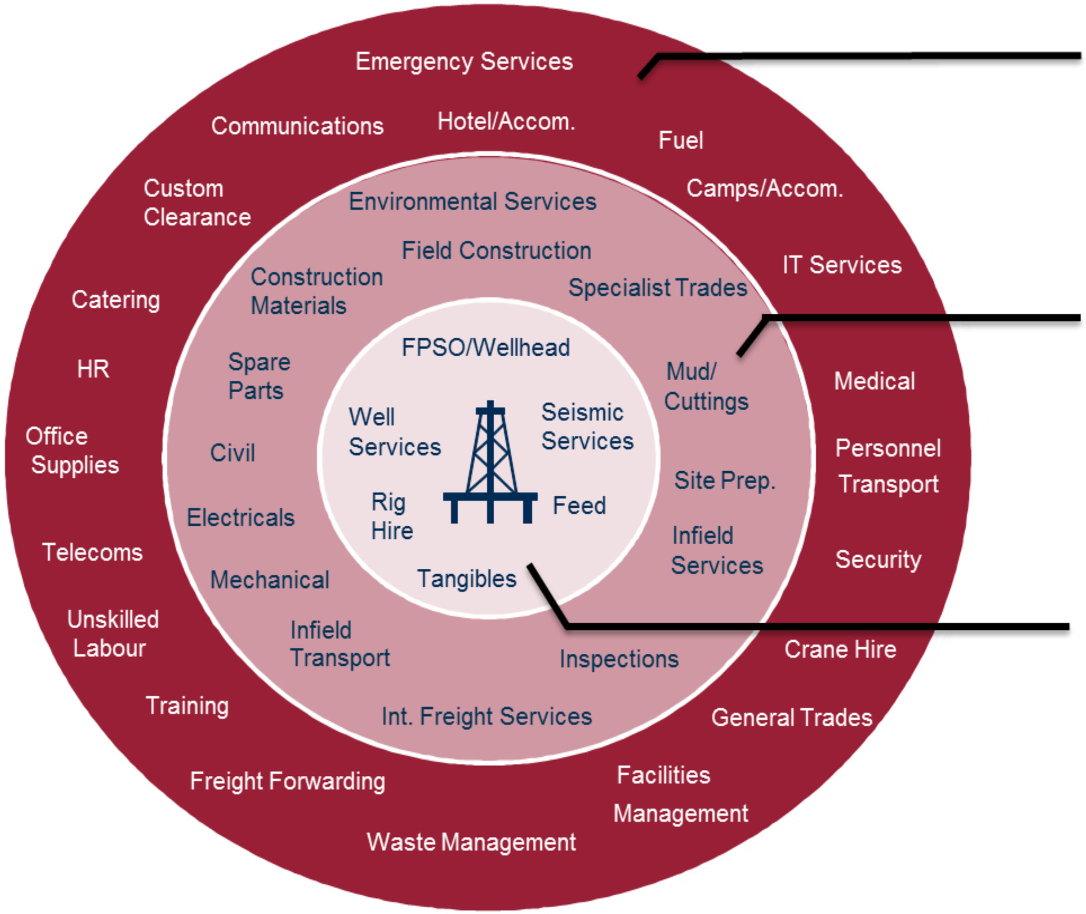
Oil Field Services

Includes companies involved in the operation, manufacture and provision of services across the value chain – at various levels of complexity.

Oil & Gas value chain



Oil & Gas value chain



INDIRECT SERVICES

- Mostly available and well serviced in KE
- Not very specialized but requires some expertise
- Need to improve standards
- Some investment required ($)

DIRECT SERVICES

- More specialized
- Stringent compliance to safety and operational standards
- Requires significant investment ($$)
- Not widely available in KE

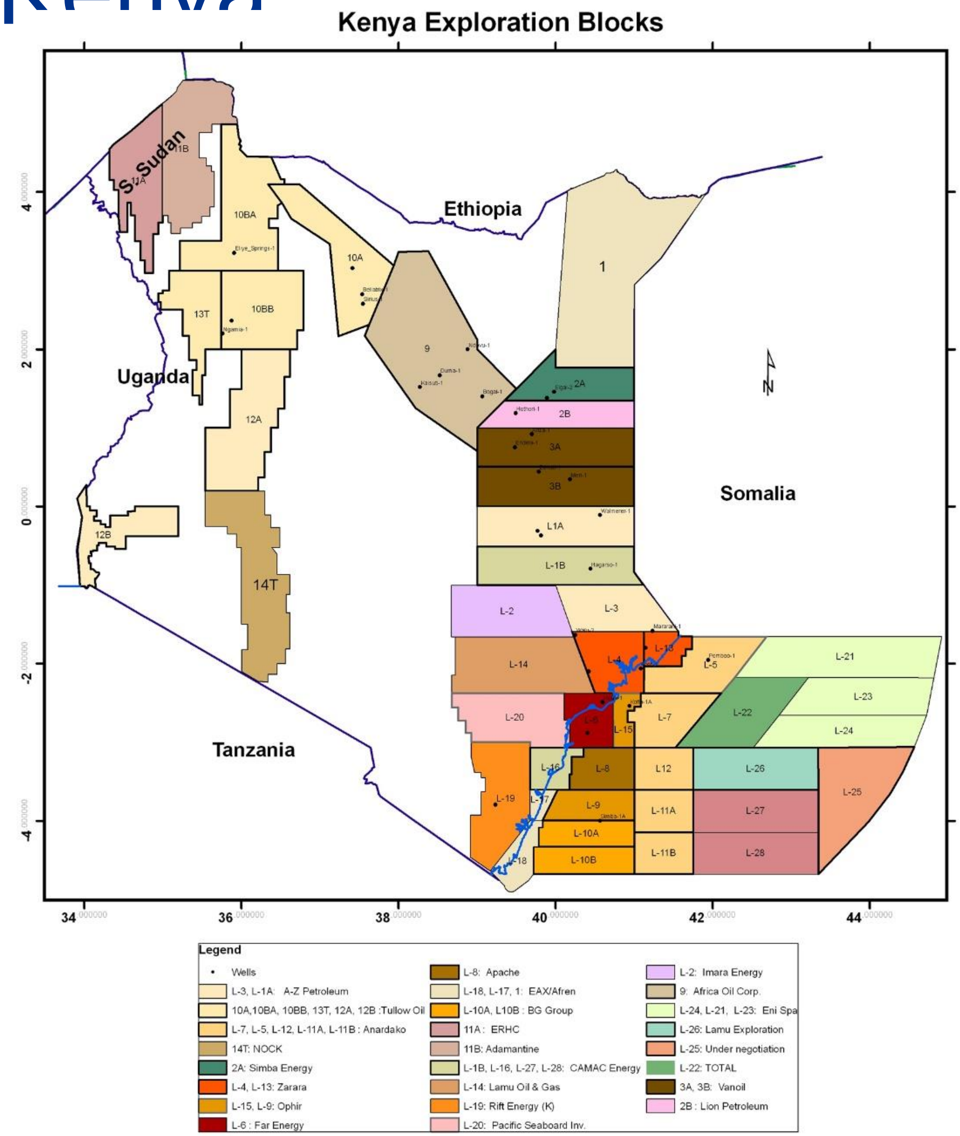
SPECIALIST SERVICES

- Highly specialized
- Strictest standards for operations and safety
- Critical services (mistakes ground operations and increase losses exponential)
- Heavy investment in service provision + R&D ($$$)
- Not available in KE

Source: Kenya Extractive Industries Development Programme, Extractives Industry Local Content Early Gap Analysis: Summary Report, September 2015

Upstream Oil & Gas in Kenya

- Kenya has four (4) petroleum exploration basin:
  - Lamu
  - Anza
  - Mandera
  - Tertiary Rift
- 46 petroleum exploration blocks currently
  - Based on geological potential to find oil
  - Licensed under PSCs
  - 44 licensed blocks
  - 23 operators
  - 9 relinquished blocks to be gazetted
- Seventy four (74) wells drilled to date
  - One additional well (Cheptuket) in 2016 with active petroleum system
- Twelve (12) hydrocarbon discoveries to date
  - Nine (9) of which are in Turkana County
  - Others are offshore Lamu and Northeastern Kenya
- Currently debating the midstream options for route-to-market



Source: National Oil Corporation of Kenya

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Most projects are in the exploration stage

Exploration

- Conducting seismic surveys
- Analysing seismic data
- Determination of prospective areas
- Conducting exploration drilling
- Appraisal of oilfields
- Determination of commerciality

Development

- Field development studies
- Analysis of most cost effective development and production methods
- Construction of facilities – production, partial process, transport to market

Production

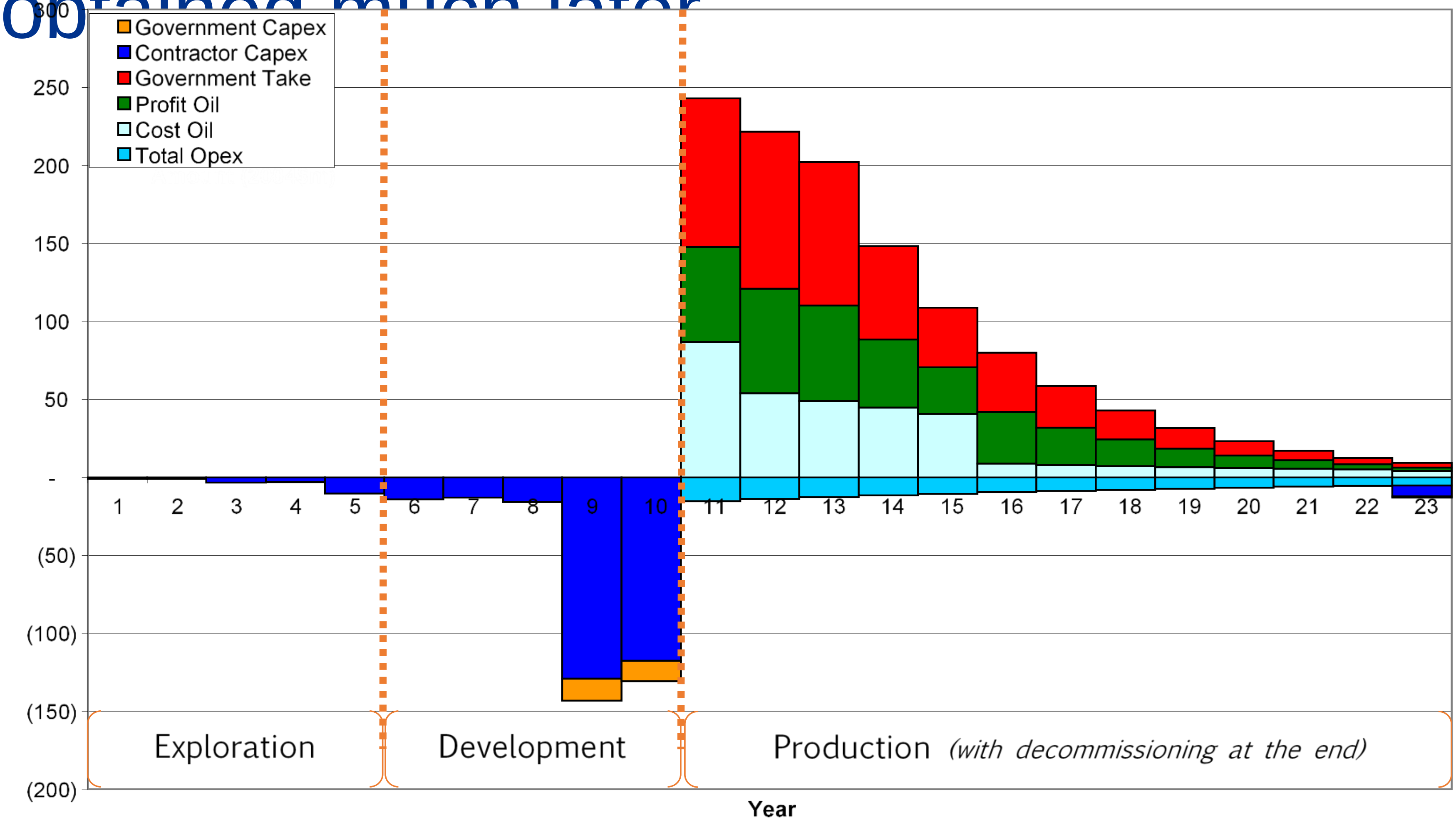
- Production of oil from wells to platform gathering facilities

Decommissioning /Abandonment

- Decommissioning of used installations and/or pipelines
- Removal of waste matter from sea bed
- Environmental monitoring of area

- Tullow/Africa Oil/Maersk Oil is furthest along
- Pancontinental - Mbawa
- Africa Oil - Sala
- BG - Sunbird
- Other operators conducting early exploration

For most projects, positive cash flow is obtained much later



Source: Kenya Extractive Industries Development Programme, Extractives Industry Local Content Early Gap Analysis: Summary Report, September 2015

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Oil & Gas upstream regulation basics

- CONSTITUTION
- Petroleum Primary +Subsidiary Legislation
- Licensing Arrangements

TYPES OF LICENSING ARRANGMENTS

License agreements
- Tax and royalty
- Concessions

Contract agreements
- PSAs or PSCs
- Service Contracts
- Participation Agreements (JVs)

Other
- Hybrids
- Farm-in agreements

Can be issued:
- Exclusively
- Non-exclusively

Features of the model PSC

Government retains title to the petroleum on behalf of the Kenyan people

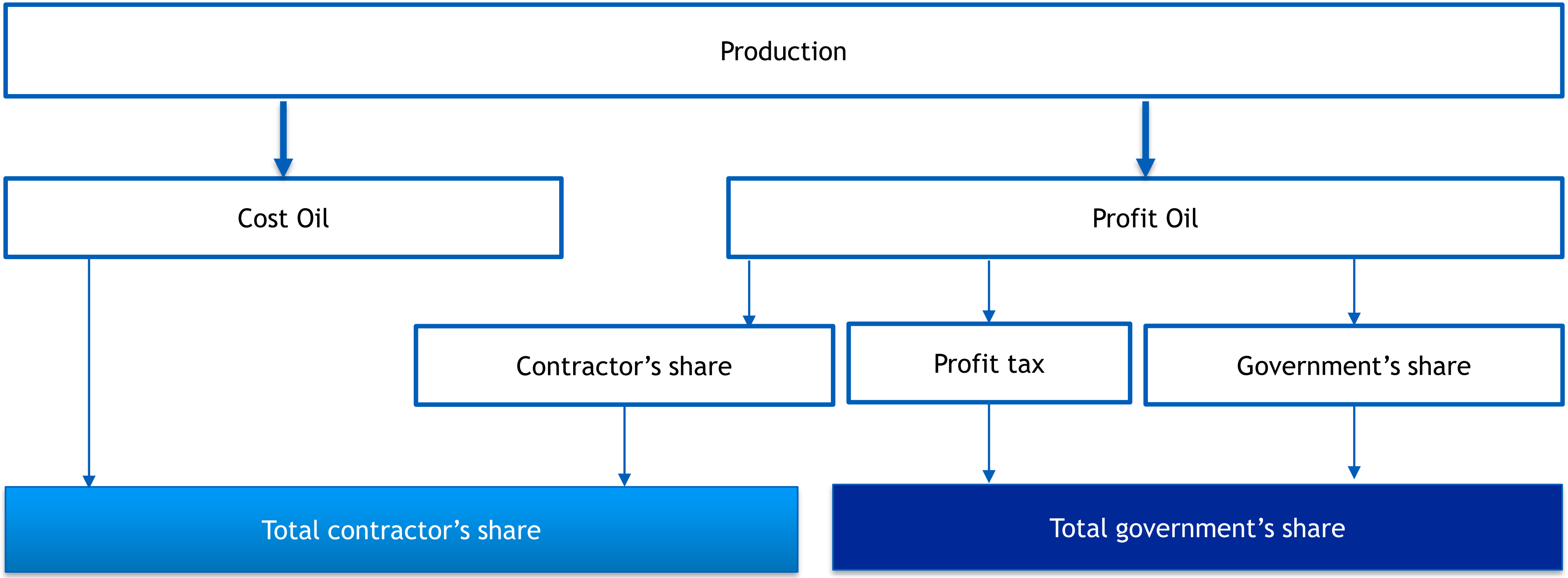
Contractors are responsible for operations through work programs

Report regularly to GoK

Contractors finance all activities at their own risk

Government may choose to participate following a commercial discovery

Features of the model PSC



Important notes:

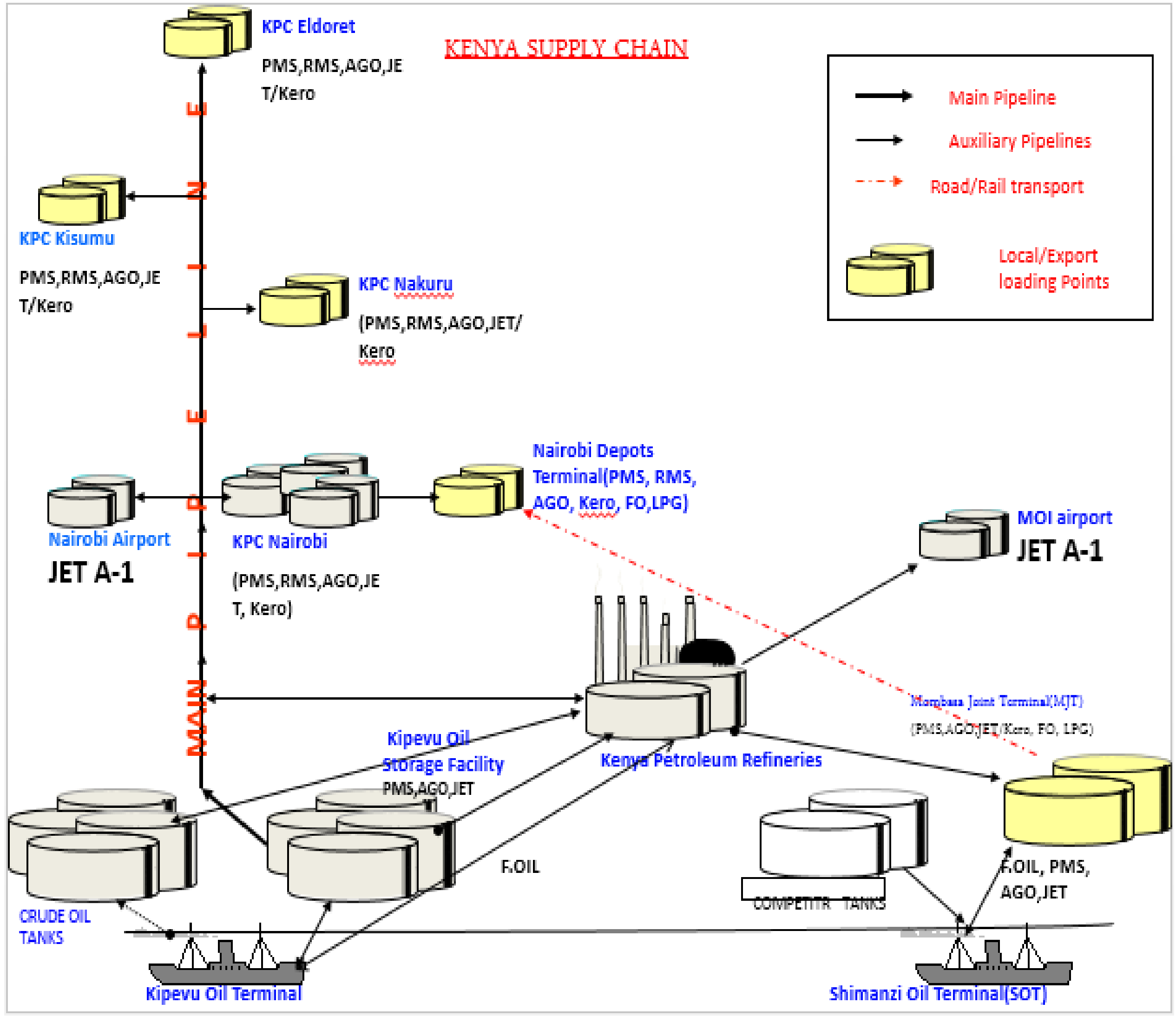
- No royalties
- Some tax paid contracts
- Ceilings for cost recovery
- Ring fencing
- Government participation will usually be included (10% - 20%)
- DROP method to calculate apportionment of profit oil (discussions to use R Factor)

Other fees:

- Signing bonuses
- Bid round fees
- Data fees
- Surface rental fees
- Training fees
- Milestone fees (e.g. declaration of commerciality, etc.)

Other things to note about the petroleum sector

- Kenya has a vibrant downstream sector which is supported by a relatively well developed network of storage and products pipeline
- Products are imported via the port of Mombasa to:
  - Kenya Petroleum Refineries Limited (KPRL) which also stopped processing crude in late 2013
  - Kenya Pipeline Company (KPC)
  - Privately owned storage
- Transportation via pipeline road and railway for deliveries to various depots at the Port and inland
- Geographical expansion feasibility study has just been undertaken by KPC
- Energy Regulatory Commission (ERC) regulates downstream petroleum including aspects of midstream



Minin
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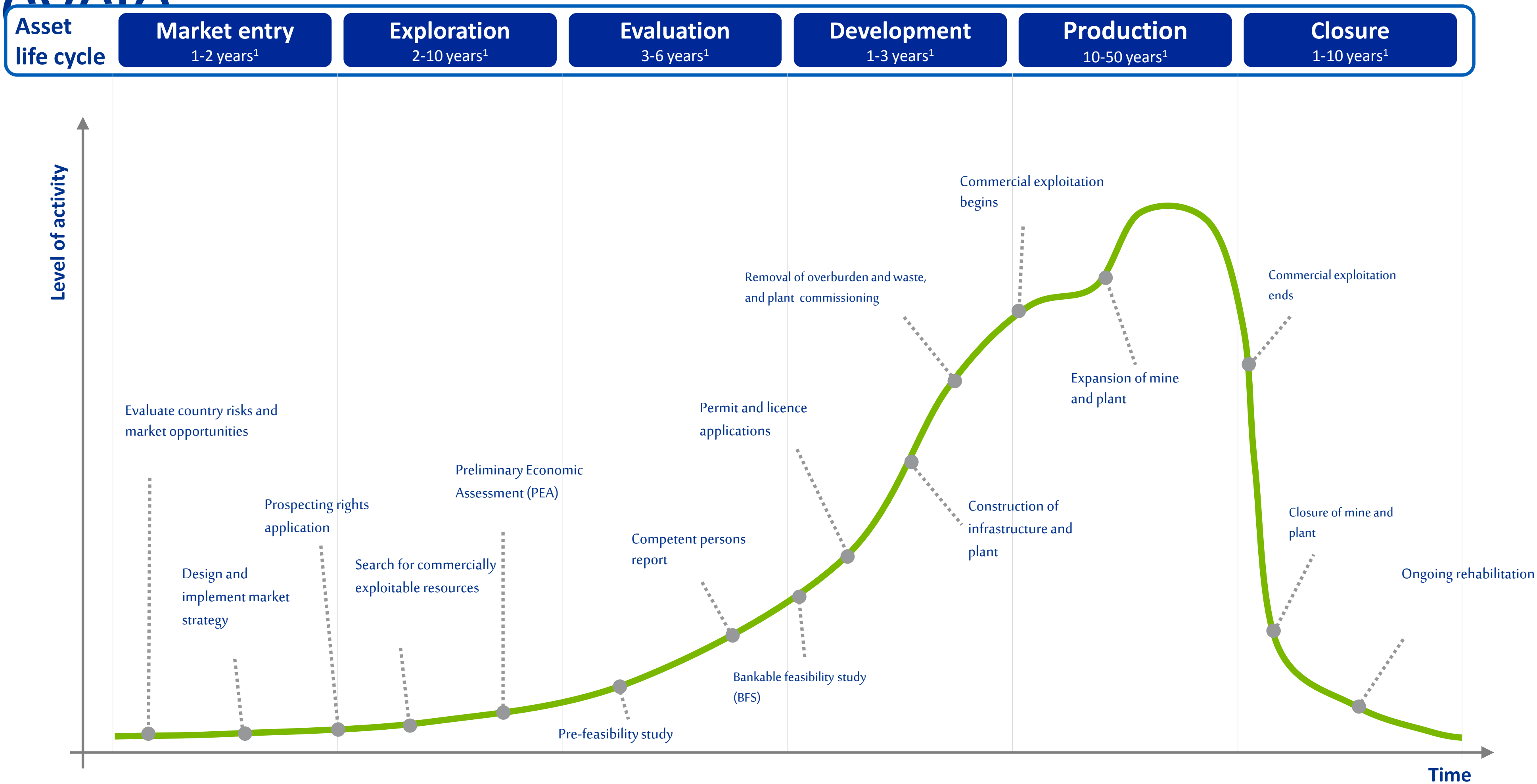
sector

Mining sector has an extended asset life cycle



Note: (1) Estimated duration of stage in the mining asset life cycle
(2) Reflects key activities only at each stage of the mining asset life cycle

Mining regulation basics

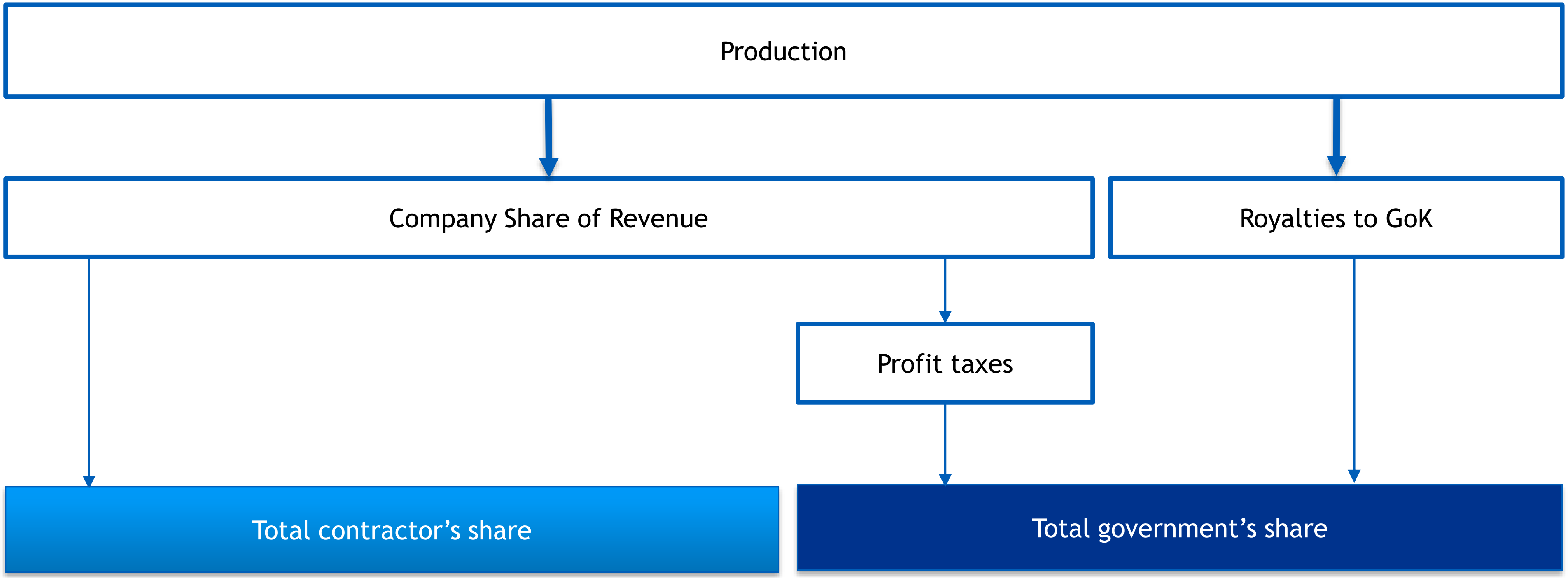
- CONSTITUTION
- Mining Primary +Subsidiary Legislation
- Licensing Arrangements

TYPES OF LICENSING ARRANGMENTS

- License agreements
  - Tax and royalty
- Prospecting licenses
  - Mining location
  - Exclusive prospective license
  - Special prospecting license
- Mining Licenses
  - Mining lease
  - Special mining lease

- Other licenses include mining dealers' license and related exporters' permits
- Prospecting rights can be issued non-exclusively

Fiscal terms in mining



Important notes:

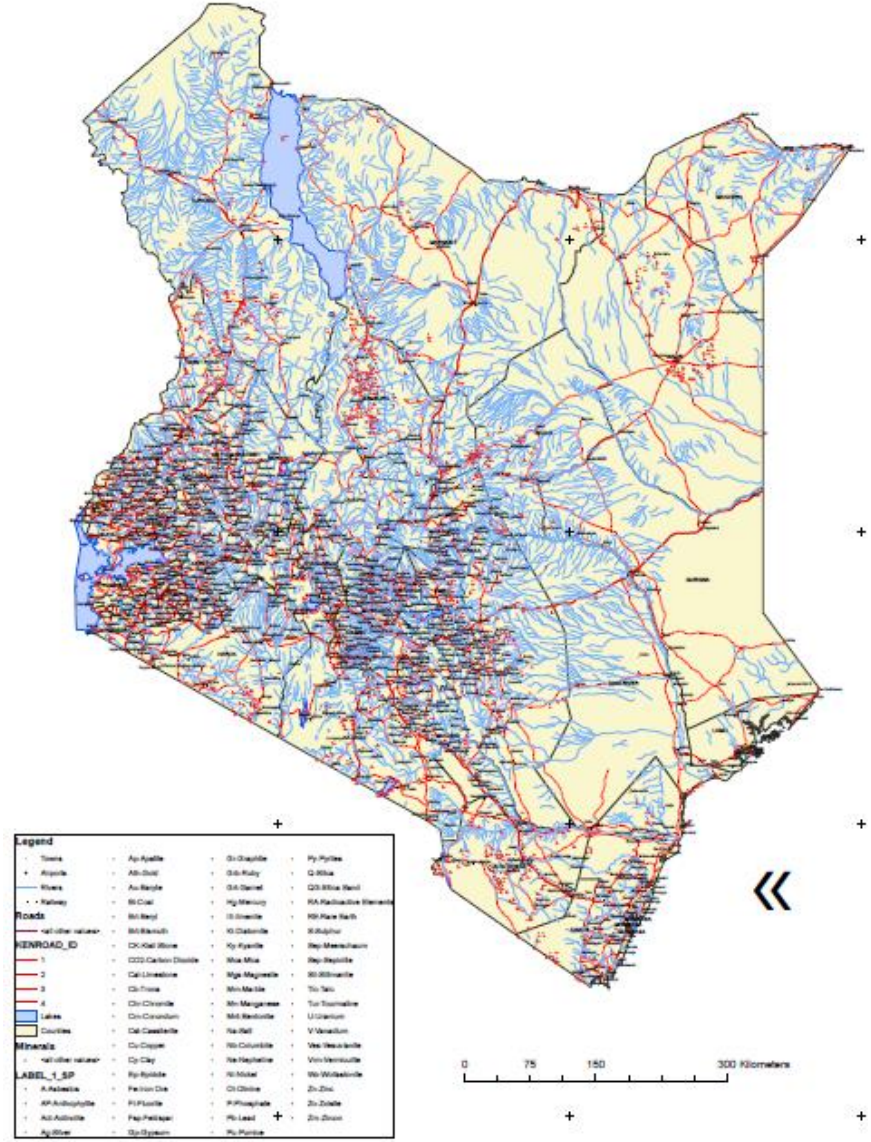
- Royalties on minerals under 1940 act under a set of different regulations
- Taxation not mentioned in the new law but assumed under the purview of the tax regulator
- New laws focusing on revising royalties rates to be more competitive
- Stability and predictability are a major focus of the fiscal regime

Other fees:

- Signing bonuses
- Data fees
- Surface rental fees
- Training fees
- Milestone fees (e.g. declaration of commerciality, etc.)

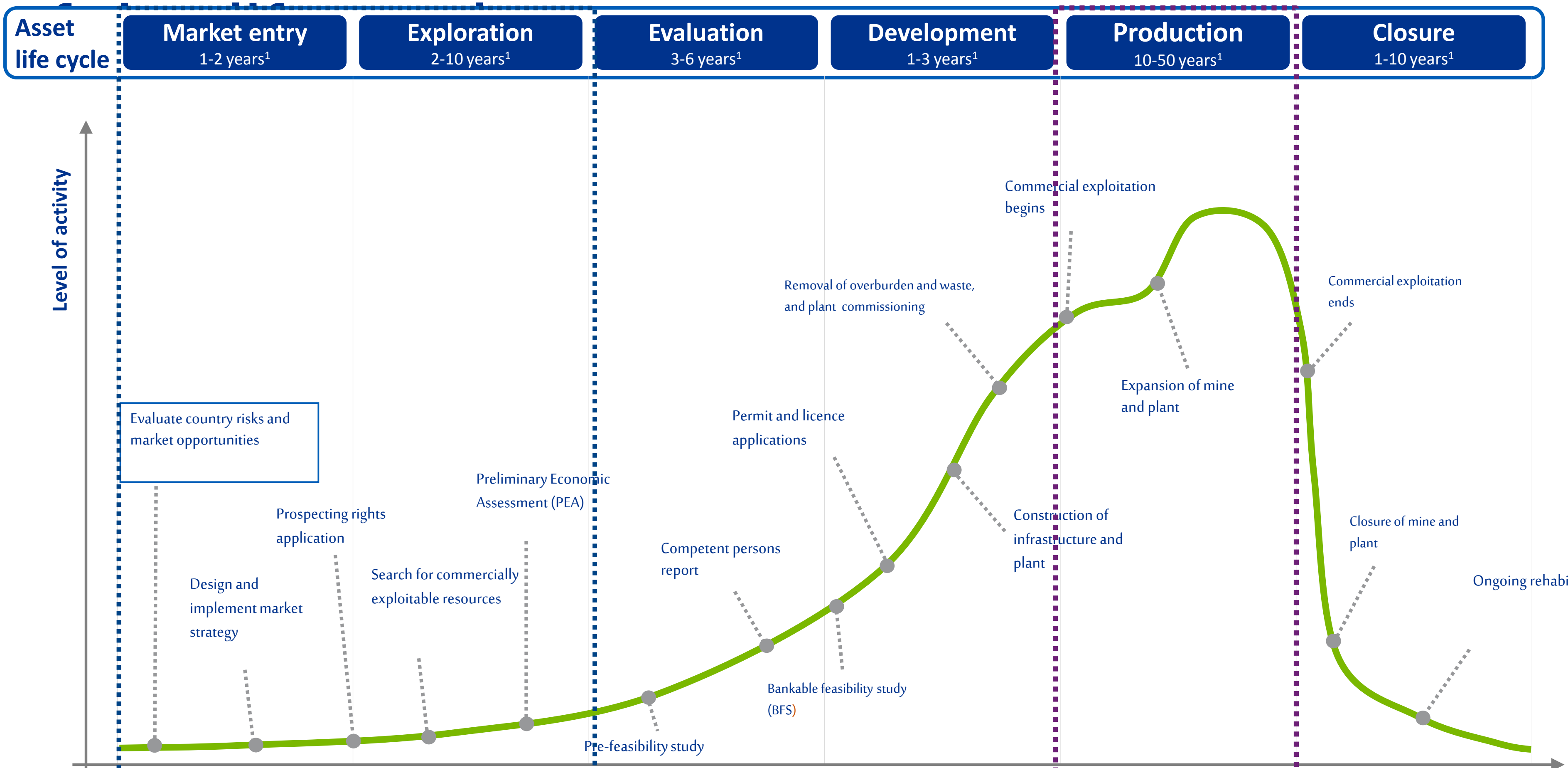
Mining in Kenya

- Kenya's mining sector contributes ~ 0.4% of GDP
- Minerals under exploitation include:
  - Mineral sands
  - Soda ash
  - Gold
  - Fluorspar
  - Diatomite
  - Salt
  - Gemstones
- Mineral sands and soda ash are the country's top earners and accounting for the already limited export revenue
- Artisanal mining contributes to the economy but not recognized by law or in productivity of the sector
- Significant investment expected in gold mining in the next few years
- Mining cadastre accessible online with information on licenses and exploration activity taking place across the country
- New Mining Bill, 2014 awaiting approval by Senate



Source: Ministry of Mining Kenya

Most projects in Kenya are in early stages



- Gold in western and northern parts
- Coal in eastern parts
- Specialty minerals

- Mineral sands
- Soda ash
- Gold
- Diatomite
- Fluorspar
- Salt
- Gemstones

Note: (1) Estimated duration of stage in the mining asset life cycle
(2) Reflects key activities only at each stage of the mining asset life cycle

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Other things to note about the mining sector

- Similar to oil and gas, exploration is driven by prospectivity as mapped out by geological data
  - Data on geological potential of Kenya remains a challenge
  - Not surprisingly, Kenya is underexplored and expenditure in mining is relatively low
  - Many licenses have no activity
- Value chain will differ slightly from mineral to mineral e.g. gold vs. mineral sands, but essentially it has the same cycle from exploration to closure/decommissioning
  - Heavy reliance on infrastructure for route-to-market
  - Water and energy are key resources to make operations viable
- Cash profile of the mining sector not very different from that of upstream oil and gas
  - Upfront investment in exploration is very high risk
  - Recovery based on quality and quantity of mineral deposits discovered

IFRS 6

Contents – IFRS 6

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Scope

- The scope of IFRS 6 Exploration for and Evaluation of Mineral Resources is limited to the recognition, measurement and disclosure of expenditure incurred in the phase covering the E&E of mineral resources.

- Although the term used is ‘mineral resources’, the definitions in IFRS 6 clarify that this extends to cover minerals, oil, natural gas and other similar non-regenerative resources meaning that it applies across the extractives industry sector

  – The limitation of scope to cover the exploration and evaluation phase means that IFRS 6 does not apply to expenditure incurred:

    ➢ In the previous prospecting phase
    ➢ In all phases after the E&E phase has been completed, including development, production, closure and rehabilitation.

Overview

- IFRS 6 Exploration for and Evaluation of Mineral Resources has the effect of allowing entities adopting the standard for the first time to use accounting policies for exploration and evaluation assets that were applied before adopting IFRSs.
- It also modifies impairment testing of exploration and evaluation assets by introducing different impairment indicators and allowing the carrying amount to be tested at an aggregate level (not greater than a segment)

Issue date

IFRS 6 was issued in December 2004 and applies to annual periods beginning on or after 1 January 2006.

Key aspects of IFRS 6

- Applies only to Exploration and Evaluation (E&E) expenditure
- Contains an exemption from certain of the requirements of IFRS, meaning that there are fewer restrictions placed on what qualifies to be capitalised as an asset (or part of an asset)
- Permits a choice of whether an entity expenses all E&E expenditure as incurred, or capitalizes that expenditure (in which case there is a choice about how much of that expenditure might be capitalized)
- Contains certain exemptions from the requirements of IAS 36 Impairment of Assets, for the purposes of assessing whether E&E expenditure which has been capitalized is impaired.

IFRS 6 – Recognition and Measurement of Exploration and Evaluation Assets

Recognition:

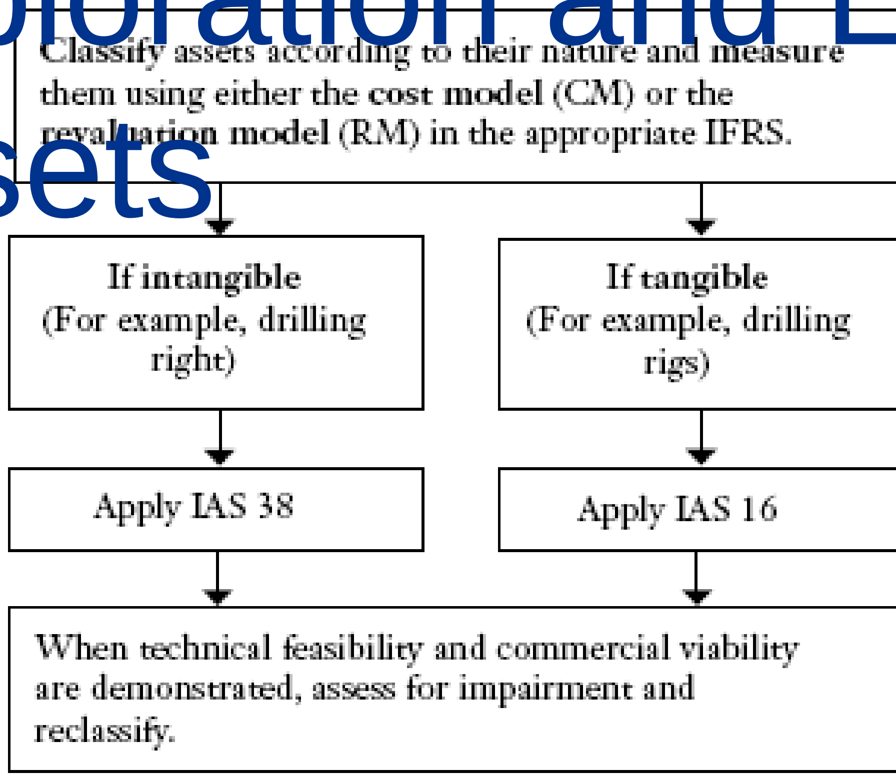
- Companies use a variety of methods to account for exploration and evaluation activities, from expensing all related costs to fully capitalizing them
- Therefore, exploration and evaluation assets are defined in terms of the policy each company chooses

IFRS 6 – Recognition and Measurement of Exploration and Evaluation Assets

- Exploration and evaluation assets are recognized at cost
- Examples of costs that may be capitalized:
  - Cost of exploration rights, geological studies, exploratory drilling and sampling, and evaluating technical and commercial viability of extraction

IFRS 6 – Recognition and Measurement of Exploration and Evaluation Assets

Classification of exploration and evaluation assets:



Measurement

- Exploration and evaluation assets shall be measured at cost.
- After recognition, an entity shall apply either the cost model or the revaluation model to the exploration and evaluation assets. If the revaluation model is applied (either the model in IAS 16 Property, Plant and Equipment or the model in IAS 38) it shall be consistent with the classification of the assets

Impairment

- The exploration and evaluation assets are tested for impairment when facts and circumstances suggest that the carrying amounts may not be recovered. The assets are also tested for impairment before reclassification out of exploration and evaluation.
- The impairment is measured, presented and disclosed according to IAS 36, ‘Impairment of assets’, except that exploration and evaluation assets are allocated to cash-generating units or groups of cash-generating units no larger than a segment.

Consider the following:

– the right to explore expires and is not expected to be renewed

– no other substantial expenditures are planned for exploration or evaluation in the area

– the entity decides to stop exploration and evaluation activities because viable quantities have not been found in the area

– although development is likely, the costs capitalized as exploration and evaluation assets exceed the amounts that are likely to be recovered

Impairment losses are taken to profit or loss – may be reversed

Presentation

- Classification of exploration and evaluation assets
  - An entity shall classify exploration and evaluation assets as tangible or intangible according to the nature of the assets acquired and apply the classification consistently.
- Some exploration and evaluation assets are treated as intangible (e.g. drilling rights), whereas others are tangible (e.g. vehicles and drilling rigs). To the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset.
- However, using a tangible asset to develop an intangible asset does not change a tangible asset into an intangible asset.

Disclosure

- IFRS 6 has an overriding disclosure requirement to include information in the financial statements that identifies and explains the amounts that have been recognized as exploration and evaluation assets. Such information should include the entity's accounting policy for the recognition and measurement of exploration and evaluation assets.
- An entity is also required to identify the amount of assets, liabilities, income and expense arising from the exploration and evaluation of mineral resources. In relation to the statement of cash flows the amount of operating and investing cash flows arising from the exploration and evaluation of mineral resources should be disclosed
- Disclosure objective: to identify and explain amounts recognized in the financial statements that result from exploration and evaluation activities
- If classified as PP&E, use IAS 16
- If classified as intangible asset, use IAS 38

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IFRS 6 - Disclosure

- Minimum disclosure:
  - Accounting policies for exploration and evaluation expenditures and their capitalization as assets
  - The amount of assets, liabilities, income, expense, and operating and investing cash flows from exploration and evaluation activities

Discussions

Q&A

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