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**PERFORMANCE AUDIT REPORT ON
PREPAREDNESS OF THE STATE DEPARTMENT
FOR PETROLEUM
TO MONITOR COSTS IN THE PETROLEUM
SECTOR**

THE NATIONAL ASSEMBLY
PAPERS LAID

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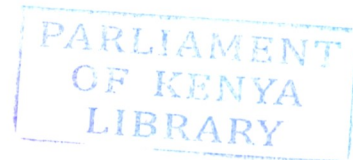
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Foreword by the Auditor – General

I am pleased to present this performance audit report on Preparedness of the State Department for Petroleum to Monitor Costs in the Petroleum Sector. My Office carried out the audit under the mandate conferred on me by Section 36 of the Public Audit Act, 2015. The Act mandates the Office of the Auditor - General to examine the economy, efficiency and effectiveness with which public money has been expended pursuant to Article 229 of the Constitution of Kenya, 2010.

Performance, financial and compliance audits form the three-pillar audit assurance framework that I have established to give focus to the varied and wide scope of the audit work done by my Office. The framework is intended to provide a high level of assurance to stakeholders that public resources are not only correctly disbursed, recorded and accounted for, but their use results in positive impacts on the lives of all citizens. The main goal of our performance audits is to ensure effective use of public resources and promote service delivery to citizens.

Our performance audits examine compliance with policies, obligations, laws and regulations and standards, and whether the resources are managed in a sustainable manner. They also examine the economy, efficiency and effectiveness with which public resources have been expended. I am hopeful that corrective action will be taken in line with recommendations in the report.

The report is submitted to Parliament in accordance with Article 229 (7) of the Constitution of Kenya, 2010 and Section 39 (1) of the Public Audit Act, 2015. In addition, I have submitted copies of the report to the Principal Secretary, State Department for Petroleum, the Principal Secretary, National Treasury and the Secretary, President's Delivery Unit.


CPA Nancy Gathungu, CBS
AUDITOR – GENERAL

25 October, 2021

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ACRONYMS

EOPS	Early Oil Pilot Scheme
EPRA	Energy and Petroleum Regulatory Authority
FDD	Full Field Development
IOC	International Oil Companies
KRA	Kenya Revenue Authority
KEPTAP	Kenya Petroleum Technical Assistance
NOCK	National Oil Corporation of Kenya
OAG	Office of the Auditor-General
PIS	Petroleum Information System
PSC	Production Sharing Contracts
SDP	State Department for Petroleum
SOP	Standard Operating Procedure
VAT	Value Added Tax

DEFINITION OF TERMS

Profit Oil: This is the crude oil remaining after deduction of royalty and cost oil from crude oil produced and saved from the contract area and delivered to the delivery point, calculated in accordance with the provisions of the Production Sharing Contract (PSC).

Tax returns: A tax return is a form(s) filed with a taxing authority that reports income, expenses and other pertinent tax information. Tax returns allow taxpayers to calculate their tax liability, schedule tax payments, or request refunds for the overpayment of taxes.

Joint Venture Partnership: A joint venture (JV) is a business arrangement in which two or more parties agree to pool their resources for the purpose of accomplishing a specific task.

Early Oil Pilot Scheme: The Early Oil Pilot Scheme (EOPS) involves trucking of the crude oil from South Lokichar Sub-Basin in Turkana County using insulated and heated tank-tainers to the Kenya Petroleum Refineries (KPRL) storage facility before export to international markets.

EXECUTIVE SUMMARY

Introduction

1. The Government, through the State Department for Petroleum (SDP), signs contractual agreements with International Oil Companies (IOCs) for purposes of petroleum exploration, development and production. The contractual agreements are in the form of Production Sharing Contracts (PSCs). IOCs are expected to finance and undertake exploration, development and production operations with some initial costs being recoverable on discovery of commercial deposits. Section 27(1) of the Petroleum (Exploration and Development), Act. Revised Edition 2012 states that the contractor shall recover petroleum costs, in respect of all petroleum operations, incurred and paid by the contractor pursuant to the provisions of the contract and duly entered in the contractor's books of account. The State Department for Petroleum is charged with the responsibility for monitoring costs incurred to determine which ones are allowable as cost recoverable.

Audit Objective

2. The audit objective was to assess the extent to which the State Department for Petroleum has put in place systems to monitor costs incurred by International Oil Companies under the Production Sharing Contracts. The specific objectives of the audit were to assess;
 - i. The extent to which SDP has systems in place to review and approve work programmes, budgets and progress reports prepared and submitted by the IOCs;
 - ii. The extent to which SDP has systems in place to ensure review and approval of recoverable cost claims from IOCs; and
 - iii. Systems put in place for SDP to coordinate with Kenya Revenue Authority on tax related cost claims.

Audit Scope

3. The audit team examined the activities of the State Department for Petroleum with regards to the systems they have put in place for monitoring of costs budgeted and incurred by International Oil Companies, in the petroleum process life cycle, as per the signed PSCs. The audit covered the period from March 2012 to July 2020. Out of the 23 licensed oil blocks, the team reviewed how SDP was monitoring blocks 10BB and 13T; the blocks with commercially viable oil. The audit also assessed the systems put in place by the State Department for Petroleum to collaborate with the Kenya Revenue Authority, in monitoring costs in the Petroleum Sector.

Summary of Audit Findings

- I. **Inadequacies in Submission, Review and Approval of Work Programmes, Budgets and Progress Reports**
 - a. **Late submission of work programmes and budgets**
4. Documentary review indicated that Tullow Oil submitted their work programmes and budgets late. In most of the years, the submission was done five months late. The late submission was attributed to Tullow Oil awaiting approvals of the work programs and budgets by the independent boards of the Joint Venture Partnership. Consequently, the IOC implemented unapproved work programmes and incurred expenditure on unapproved budgets. The works done on unapproved budgets and work programmes may later bring about disputes between the IOC and SDP on items and amounts claimed as recoverable.

b. Irregular submission of quarterly progress reports by the International Oil Company

5. Review of correspondence files for blocks 13T and 10BB revealed that Tullow Oil did not submit their quarterly reports consistently. For the period 2012 to 2019, only 43% and 53% of the reports for blocks 13T and 10BB, respectively, were submitted. In addition, only 18% of the quarterly reports for each block met the required submission timeframes. There was no follow up by SDP on the reasons for the delay and non-submission of the quarterly reports. As a result, SDP was not incorporating information from the progress reports in its decision-making process.

c. No Evidence of reviews being conducted by SDP on submitted work programmes, budgets and actual expenditure

6. There was no evidence in the correspondence files indicating any suggested modifications or revisions on the work programmes and budgets from SDP to Tullow Oil. The work programmes and budgets were approved on the same day when oral presentations were done. This was an indication that sufficient time was not allocated for reviews of the same
7. There were variances between budgeted and actual expenditure in the returns submitted. While this may be a normal commercial occurrence. No queries were made by SDP or explanation by Tullow Oil on the causes and effect of the variances. Further, there was no communication from Tullow Oil to SDP requesting for approval of the modified budgets. The variance may give the IOCs undue advantage or disadvantage to the government. All variances should be analysed, the cause explained, and approval given.

II. SDP was Developing Systems to Enhance Monitoring of Activities and Cost Claims of International Oil Companies

a. SDP was developing a commercial database to facilitate in monitoring the activities of International Oil Companies

8. As at the time of the audit, SDP was in the process of setting up a database to store petroleum data. Implementation of the database started in May 2019 and was expected to go live in October 2020. The database once fully implemented will allow for analysis of various variables for each block over the period of operation. The database will be useful for purposes of cost recovery audits which are quite comprehensive as they involve massive data. SDP will also be in a position to use the available data for identification of areas to focus on for monitoring of petroleum costs.

b. Inadequate technical staff to monitor costs in the petroleum sector

9. Documentary review of the staff establishment as at July 2020 revealed that SDP had only 34 technical staff against the required 171. Due to lack of the required expertise at SDP, the department has not been able to effectively monitor costs in the petroleum sector. This might lead to IOCs recovering non- allowable costs that would have otherwise not been recovered had monitoring been carried out. Ultimately, this will reduce the amount of government share from revenues generated from the oil resources.

c. Cost recovery statements were not detailed and were inconsistently submitted

10. Blocks 10BB and 13T owned by Tullow Oil BV have been in operation since 2007 and 2008, respectively. Despite the requirement to submit cost recovery statements quarterly, documentary review revealed that Tullow Oil BV submitted cost recovery statements for the first time in September 2016. The statements covered the period

from quarter one, 2011 to quarter two, 2016. For the period 2017 and 2018, there were instances of late and non-submission of the statements.

11. Further, section 1.2.1 of the Accounting Procedures requires the contractor to maintain financial accounts necessary to record in reasonable detail. Documentary review revealed that the cost recovery statements submitted did not have a breakdown of the expenditure incurred.

III. SDP had a Draft Memorandum of Understanding with KRA on Oil and Gas Activities in Kenya

12. As at the time of the audit, no framework had been put in place by the State Department for Petroleum for the Kenya Revenue Authority to be involved in cost recovery audits so as to provide expert advice on tax related claims. However, as at July 2020, SDP had prepared a draft Memorandum of Understanding on how it would collaborate with KRA on oil and gas activities in Kenya. SDP had shared the draft Memorandum of Understanding with KRA and was awaiting feedback. In addition, the Government has enacted the Petroleum Act, 2019 which provides for the Commissioner General of KRA or an authorised representative to be member of the National Upstream Petroleum Advisory Committee. This will enhance collaboration between the State Department of Petroleum and the Kenya Revenue Authority.

IV. Inadequate Monitoring and Evaluation of the Operations of International Oil Companies

13. The State Department for Petroleum rarely carried out monitoring of information relating to costs incurred by the IOC. There has also been no evaluation carried out on operations of the IOC. SDP provided only two monitoring reports; For Erut 1, dated January 2017 and a report for tracking transportation of Early Oil, dated September 2019. However, the reports were not comprehensive on all the areas that needed to be monitored and comprised of information relating to activities for two months only.

14. Interviews with SDP staff revealed that there were no systems or standard operating procedures in place to guide the frequency and methodology of how monitoring and evaluation should be carried out and reported. Further, SDP did not have a specific budget line for monitoring of costs in the petroleum sector. The budget for monitoring was derived from a vote head that had line items for pre-feasibility, feasibility, appraisal studies and project supervision. This made it difficult to establish exactly how much was budgeted and utilised in monitoring activities of the IOC.
15. Lack of standard operating procedures and a specific budget line for monitoring activities resulted to minimal monitoring of IOC activities. Consequently, the Government might not be able to verify the authenticity of costs incurred by IOCs, due to lack of real time monitoring.

Conclusion

16. The Government had identified gaps in the petroleum legal framework and put in place laws to move the country forward from the exploration to the development stage with the enactment of a legal regime of the
17. Energy Act. 2019 and the Petroleum Act. 2019. The Act. created the Energy and Petroleum Regulatory Authority (EPRA). The Authority will be the energy sector regulatory agency responsible for economic and technical regulation of the petroleum sub sectors, among others. However, more effort needs to be put to ensure that Kenya accrues maximum benefit from its petroleum reserves as standardised formats of reporting. Failure by the Government to institute standardised measures for monitoring costs in the petroleum sector will reduce the government share of profit oil and the reserves may deplete before the country benefits from the resource. Countries in Africa that did not put in place proper measures have not benefited from their petroleum resources, with a large proportion of their citizens still living in abject poverty, what is commonly referred to as a resource curse.

18. Arising from the audit, it was evident that SDP had not put in place a standardised system to monitor costs incurred by International Oil Companies under the Production Sharing Contracts. As at the time of the audit, SDP did not have a checklist to verify particulars submitted by IOCs leading to submission of work programmes, budgets and progress reports that were not comprehensive. There was lack of follow up by SDP on timely submission leading to late and inconsistent submission of the same. Further, no reviews were done on the submitted work programmes, budgets and progress reports.
19. It was established that SDP was in the process of developing systems for receipt and storage of data on cost claims from IOCs. The systems will enhance the tracking, review and analysis of the cost claims.
20. The State Department for Petroleum lacked technical staff to review cost claims, therefore, posing a risk of non-recoverable costs being recovered by IOCs. Further, cost recovery statements were submitted inconsistently and were not detailed.
21. There was lack of coordination and synergy between SDP and the Kenya Revenue Authority (KRA) to ensure involvement of KRA during cost recovery audits, for expert advice on tax related matters. However, as at the time of the audit, SDP had developed a Memorandum of Understanding on how to collaborate with KRA on tax related matters.

Recommendations

22. In view of the findings and conclusion of this audit, the Auditor- General proposes the following recommendations for implementation by the State Department for Petroleum. This is aimed at improving the monitoring of costs in the Petroleum sector, to ensure that the Government gets its rightful share of profit oil, once production begins.

23. To ensure timely submission of work programmes, budgets and progress reports, the State Department for Petroleum should:

- i. Consider aligning its submission timelines for work programmes, budgets and progress reports with the meeting timeframes of the Joint Venture Partnerships. This will ensure that Tullow Oil does not implement unapproved work programmes and budgets.
- ii. Ensure that they have the required technical staff to carry out reviews on submitted work programmes and budgets.
- iii. Develop standard operating procedures detailing the system of receipt for submission, review and follow up of work programmes, budgets and progress reports. This will ensure timely receipt, thorough review and feedback to International Oil Companies.

24. To ensure that there are systems in place for review and approval of cost claims from International Oil Companies, the State Department for Petroleum should:

- i. Fast track the finalization and implementation of the database for collection and storage of petroleum data. This will ensure that there are standardised procedures on how petroleum data should be stored for ease of review and access of data for monitoring costs in the petroleum sector.
- ii. Ensure training and capacity building of required technical staff to carry out cost recovery audits. This will ensure that cost recovery audits are carried in a timely manner and non-allowable costs are not approved for recovery purposes.
- iii. Develop a checklist for receipt of submitted cost recovery statements to ensure that the statements have all the required details.

- iv. Develop timeframes within which follow up for submission of cost recovery statements should be made. This will ensure submission of all cost recovery statements, for timely audit of the statements.
- v. Fast track the finalization, signing and implementation of the Memorandum of Understanding with the Kenya Revenue Authority (KRA) to collaborate and have a coordinated approach on tax matters in the oil and gas activities. The collaboration will also ensure the Ministry receives expert advice on tax related matters from KRA

25. To ensure efficient monitoring of the activities of International Oil Companies (IOCs), SDP should develop standard operating procedures on monitoring and evaluation. This will ensure that the State Department for Petroleum has up to date information on the activities of IOCs, for decision making purposes and timely corrective action.

CHAPTER 1: BACKGROUND TO THE AUDIT

Introduction

- 1.1 In March 2012, Kenya discovered what was considered to be commercially viable oil, in Turkana County. This was followed by further discoveries of nine sites, in the same Tertiary Rift Basin, in blocks 10BB and 13T. An Early Oil Pilot Scheme was initiated by year-end 2017, where crude oil was trucked to the port for export. The initial plan was to have EOPS run for a period of 18 months, with a Full Field Development expected to become operational in 2022. The first export of the early oil amounting to 200,000 barrels was made in August 2019. A second consignment was set for sale in February 2020, however, the programme was postponed due to heavy rainfall destroying the road network in the region and outlying areas.
- 1.2 The Government, through the State Department for Petroleum (SDP), signs contractual agreements with International Oil Companies (IOCs) for purposes of petroleum exploration, development and production. The contractual agreements are in the form of Production Sharing Contracts (PSCs), which set the contract terms between the Government and IOCs. IOCs are expected to finance and undertake exploration, development and production operations, with some of the initial costs being recoverable on discovery of commercial deposits.
- 1.3 Section 27(1) of the Petroleum (Exploration and Development), Act. Revised Edition 2012 states that the contractor shall recover the petroleum costs, in respect of all petroleum operations, incurred and paid by the contractor pursuant to the provisions of the contract and duly entered in the contractor's books of account. The State Department for Petroleum has been charged with the responsibility of monitoring costs incurred to determine which ones are allowable as cost recoverable.
- 1.4 As at the time of the audit, SDP had contracted a consultant to conduct an exercise based on agreed upon procedures, on the recoverable costs for the period 2010 to 2018. Prior

to this, no audit had been conducted on recoverable costs, which had accumulated since the signing of contracts in 2007 and 2008. As per the signed PSCs, there is a two-year limit within which books and accounts of IOCs can be audited, in the absence of an audit, the contractor's books and accounts are deemed to be correct. If an audit is not carried out within the required timelines, it presents a risk of some costs that may not be allowable for cost recovery being recovered by the IOCs, once production begins. Cost recovery audits are supposed to ensure that the amount of revenue the Government and the people of Kenya ultimately receive from the oil production, is the rightful share.

Motivation for the Audit

- 1.5 The Auditor-General authorized the audit after considering the following factors;
- i. Petroleum exploration, development and production are capital-intensive ventures. Investors invest their capital with hope of high returns in the future. Most of the costs incurred during these stages are recoverable on discovery of commercially viable deposits. There is therefore a need for the Government to carry out timely monitoring to ensure that only recoverable costs are claimed by IOCs. An audit was necessary to find out whether the State Department for Petroleum is carrying out timely monitoring of costs incurred by IOCs.
 - ii. Cost recovery is a technical area that requires specialized skills. An audit was necessary to find out whether SDP has staff with relevant skills and knowledge to monitor costs being incurred by the IOCs.
 - iii. The Government entered into a contract with Tullow Oil for blocks 10BB and 13T, in 2007 and 2008, respectively. As at the time of the audit, SDP did not have a record of audited recoverable costs, 12 years later, since exploration began on the two blocks. This was despite the IOC having had a successful exploration phase that led to discovery of commercially viable oil in 2012 and subsequently, the launch of Early Oil Pilot Scheme in June 2019. Approximately 200,000 barrels of

early oil was exported in August 2019. Therefore, there was need to conduct an audit to determine SDP's preparedness to monitor recoverable costs. This is especially because recoverable costs determine the amount of revenue that will accrue to the government from profit oil, once production begins.

- iv. Revenue generated from the petroleum sector has the potential to substantially transform Kenya's economy as well as the livelihoods of its people. The transformation can only be achieved if agencies charged with the responsibility of managing the petroleum sector are well prepared to monitor costs incurred by IOCs. This will eventually ensure that the Government gets a fair share of oil revenue, once production begins.

CHAPTER 2: DESIGN OF THE AUDIT

Audit Objective

- 2.1 The audit objective was to assess the extent to which the State Department for Petroleum has put in place systems to monitor costs incurred by International Oil Companies under the Production Sharing Contracts. The specific objectives of the audit were to assess:
- i. The extent to which the State Department for Petroleum has systems in place to review and approve work programmes, budgets and progress reports prepared and submitted by International Oil Companies;
 - ii. The extent to which the State Department for Petroleum has systems in place to ensure review and approval of recoverable cost claims from International Oil Companies; and
 - iii. Systems put in place for the State Department for Petroleum to coordinate with the Kenya Revenue Authority, on tax related cost claims.

Audit Scope

- 2.2 The audit examined the activities of the State Department for Petroleum with regards to systems put in place for monitoring of costs budgeted and incurred by International Oil Companies, in the petroleum process life cycle, as per the signed or model Production Sharing Contracts. The audit covered the period March 2012 to July 2020. Out of the 23 licensed oil blocks, the team reviewed how the State Department for Petroleum was monitoring blocks 10BB and 13T; the blocks with commercially viable oil. The audit also assessed the systems put in place by the State Department for Petroleum to collaborate with the Kenya Revenue Authority, in monitoring costs in the petroleum sector.

Audit Criteria

- 2.3 Since PSCs for blocks 10BB and 13T were signed before the Petroleum Act, 2019 and the Energy Act, 2019 were enacted, the audit assessment criteria were drawn from; the

Petroleum (Exploration and Development), Act. revised Edition 2012, with the annexed Production Sharing Contracts (PSCs) in the Act for Block 10BB and 13T and best practice in monitoring operations. The criteria are detailed below;

- i. According to Section 18 (1 & 2) of the Petroleum (Exploration and Development), Act. Revised Edition 2012 (1) The contractor shall submit and orally present to the Cabinet Secretary one (1) month after the effective date, a detailed statement of the exploration work programme and budget for the first contract year; (2) That the contractor shall submit and orally present to the Cabinet Secretary three (3) months before the end of each contract year, a detailed statement of the exploration work programme and budget for the next contract year.
- ii. According to Section 18(3) of the Petroleum (Exploration and Development), Act. revised Edition 2012, the Cabinet Secretary may submit to the contractor, within thirty (30) days of the receipt of the annual exploration work programme and budget, suggest modifications and revisions thereof. The contractor shall consider the inclusion of such suggested modifications and revisions in light of good international petroleum industry practice and shall provide the Cabinet Secretary with the exploration work programme and budget which the contractor has adopted.
- iii. Section 27(1) of the Petroleum (Exploration and Development), Act. revised Edition 2012. states that the contractor shall recover the petroleum costs, in respect of all petroleum operations, incurred and paid by the contractor pursuant to the provisions of the contract and duly entered in the contractor's books of account.
- iv. Section 30 (3&4) of the Petroleum (Exploration and Development), Act. revised Edition 2012 requires that the Government may audit the books and accounts of the IOCs within two (2) calendar years of the period to which they relate and shall complete that audit within one (1) calendar year. In the absence of an audit within

two (2) calendar years or in the absence of notice to the contractor of a discrepancy in the books and accounts, within three (3) calendar years, of the period to which the audit relates, the contractor's books and accounts shall be deemed correct.

- v. Section 5 (c) of the Petroleum (Exploration and Development), Act. revised Edition 2012, states that the Cabinet Secretary shall supervise petroleum operations carried out under a petroleum agreement.
- vi. Detailed criteria drawn from the Production Sharing Contract for blocks 10BB and 13T are on **Appendix 1**.

Methods Used to Gather Audit Evidence

- 2.4 The audit was conducted in accordance with performance auditing guidelines issued by the International Organization of Supreme Audit Institutions (INTOSAI) and audit policies and procedures established by the Office of the Auditor-General (OAG). The guidelines and policies fulfil the requirements of the International Standards on Auditing.
- 2.5 To understand the operations of SDP with regards to monitoring of costs in the petroleum sector, the team reviewed the following documents; The Petroleum (Exploration and Production) Act, Revised Edition 2012, The newly enacted Petroleum Act, 2019, The newly enacted Energy Act, 2019, Production Sharing Contracts for blocks 13T and 10BB, correspondence files for blocks 13T and 10BB and other documents listed in **Appendix 2** of this report.
- 2.6 To gain an understanding of how SDP monitors costs in the petroleum sector, the team interviewed SDP staff involved in monitoring costs in the petroleum sector. The team also interviewed KRA staff in the Petroleum Monitoring Unit, Domestic Taxes Department and the Income Tax unit. **Appendix 3** outlines the list of officials interviewed during the audit and the purpose of conducting the interviews.

CHAPTER 3: DESCRIPTION OF THE AUDIT AREA

Background

- 3.1 The Ministry of Petroleum and Mining was established to provide policy direction in the management of the extractive sector in the country. This includes development of Petroleum and Mining policies, creating a favourable legal and regulatory environment for investment and building capacity for effective management of programs and projects. The Ministry has two State Departments; the State Department for Petroleum and the State Department for Mining.
- 3.2 The State Department for Petroleum (SDP) was established in 2016, through Executive Order No.1 of 2016. Until early 2019, the mandate of SDP included spearheading all petroleum operation programmes in the country, including; policy formulation, review of fiscal, legal and regulatory framework, monitoring and supervision of oil and gas exploration, development and production activities. The mandate on regulation of the Petroleum sub sector has since been moved to the Energy and Petroleum Regulatory Authority (EPRA), as per the Energy Act, 2019.
- 3.3 One of SDP's key objective is to develop conducive petroleum policies, legal and regulatory framework to attract increased investments in the country's petroleum sector. The legal framework is to be implemented by the Energy and Petroleum Regulatory Authority. As at the time of the audit, EPRA was still to take up implementation of the legal framework.

Functions of the Energy and Petroleum Regulatory Authority

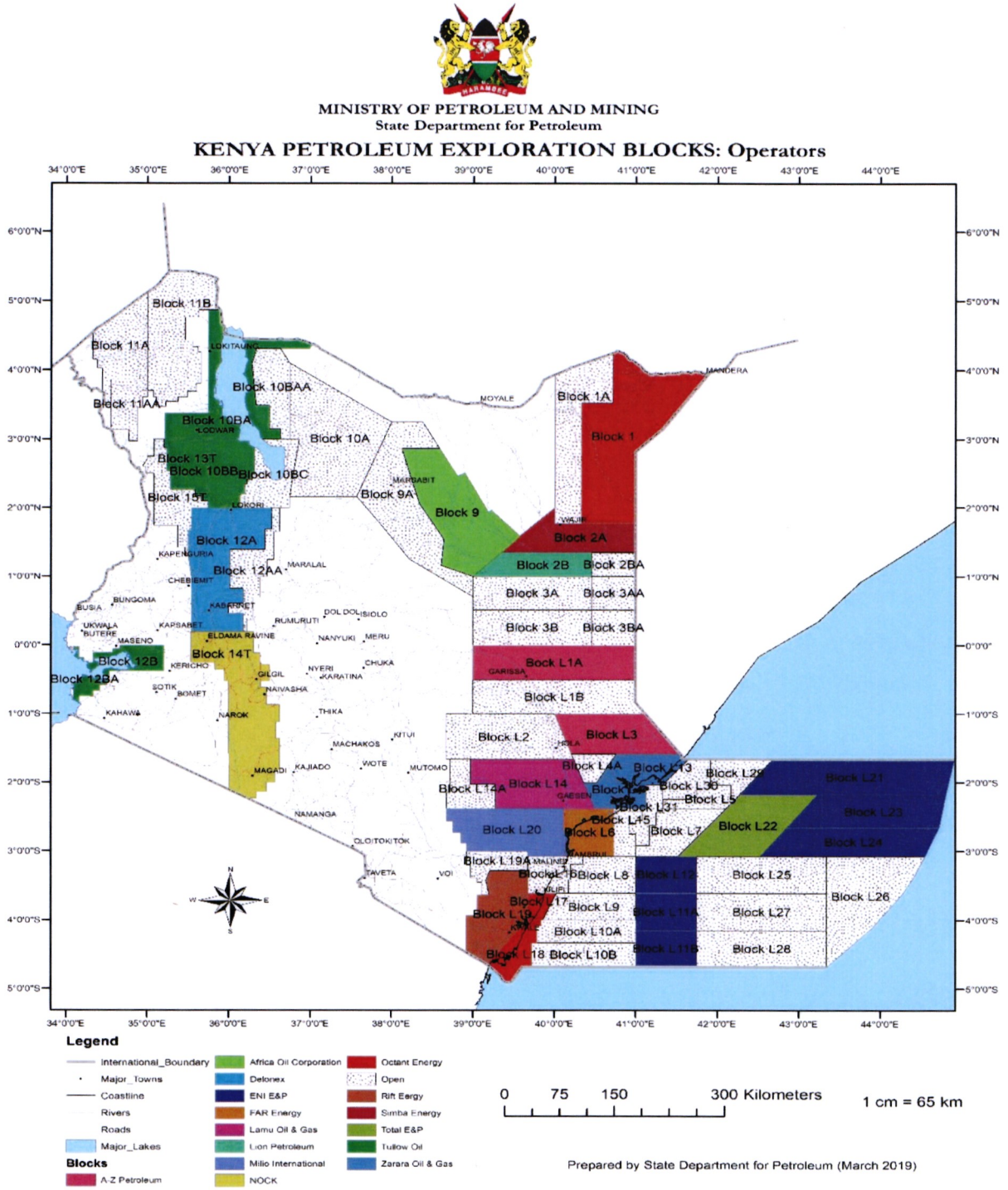
- 3.4 The Authority is the energy sector regulatory agency responsible for economic and technical regulation of the petroleum sub sectors, among others. The functions include:

- i. Regulate, monitor and supervise upstream petroleum operations in Kenya in accordance with the law relating to petroleum, the regulations made thereunder and the relevant petroleum agreement;
- ii. Provide such information and statistics in relation to upstream petroleum operations in Kenya to the Cabinet Secretary responsible for matters relating to petroleum as may be required from time to time;
- iii. Collect, maintain and manage upstream petroleum data;
- iv. Receive, review and grant an application for a nonexclusive exploration;
- v. Co-ordinate the development of upstream petroleum infrastructure and promote capacity building in upstream petroleum operations;
- vi. Inspect and test any machinery or equipment that has been used, is used or shall be used in upstream petroleum operations;
- vii. Assess field development plans and make recommendations to the Cabinet Secretary responsible for matters relating to petroleum for approval, amendment or rejection of the plans;
- viii. Assess tail-end production and cessation of upstream petroleum operations and oversee decommissioning by a contractor;
- ix. Verify the measurements of petroleum production to allow for estimation and assessment of royalties and profits of oil and gas due to the National Government;
- x. Verify the recoverable cost of oil and gas due to the parties to a petroleum agreement; and
- xi. Audit contractors for cost recovery.

Overview of the Petroleum Sector in Kenya

3.5 As at April 2019, Kenya had 61 oil blocks made up of 24 licensed active blocks, 18 never licensed blocks and 19 open blocks as detailed in **Appendix 4**. The distribution of oil blocks is shown in **Figure 1**.

Figure 1: Oil Exploration Blocks in the Country



Source: State Department for Petroleum

3.6 Out of the 23 licensed active blocks, two had discovered commercially viable oil and were at the early oil stage. The Full Field Development (FDD) is expected to become operational in 2022.

Organization of the Petroleum Sector in Kenya

3.7 The petroleum sector is organized into three sections: the upstream, mid-stream and downstream.

Upstream petroleum

3.8 The upstream section involves the process of exploration, development and production of crude oil and natural gas. Kenya has four (4) petroleum exploration basins these are: Lamu, Anza, Mandera and Tertiary Rift. Oil and gas exploration in the country began in 1956 and the breakthrough came in March 2012 with the discovery well –Ngamia 1 in Lokichar, Turkana County.

Midstream operations

3.9 The mid-stream section revolves around storage, refining and transportation of crude oil into consumable petroleum products. Currently, Kenya imports all its petroleum products requirements. The Ministry coordinates this activity with oil marketing companies, through a process known as an Open Tender System. The Kenya Pipeline Company provides product movement infrastructure, including storage and oil pipeline services.

Downstream operations

3.10 In the downstream section, refined products are made available to consumers through supply and distribution, for example at petrol stations. Distribution and marketing of petroleum products is done by oil marketing companies. The National Oil Corporation of Kenya (NOCK) is the state body operating downstream through operating Petrol Stations. NOCK was also involved in upstream activities through well exploration on one block.

Classification of Costs in the Petroleum Sector

3.11 Subject to the provisions of the contract, the contractor shall bear and pay costs and expenses necessary to conduct petroleum operations. Such petroleum costs are recoverable by the contractor in accordance with the provisions of the contract and are detailed in **Appendix 5**. The costs are classified as detailed below;

- i. **Exploration costs-** in respect of the contract area, are those costs which relate to exploration operations incurred in accordance with an approved annual exploration and appraisal work programmes and budgets. They include for the purposes of accounting, the evaluation operations in respect of a discovery.
- ii. **Development costs-** in respect of a development area, are those costs incurred in respect of the activities carried out in accordance with an approved development plan and the relevant annual development work programmes and budgets, and consists of: before the commencement of commercial production in a development area, those costs whether of a capital or operating nature, which relate to development operation; and from the commencement of commercial production in a development area, those costs of a capital nature only, which relate to the continuation of the development of the commercial discovery and investments, for the recovery of petroleum from such a discovery.
- iii. **Production costs-** in respect of a development area, are those costs of an operating nature only, excluding development costs and decommissioning costs, which relate to production operations carried out from the commencement of commercial production in respect of such development area in accordance with approved annual production work programmes and budgets.
- iv. **Decommissioning costs-** in respect of a development area, are those costs or contributions to the decommissioning fund related to abandonment and decommissioning operations.

Process Description for Monitoring Costs in the Petroleum Sector

3.12 The process for monitoring costs in the Petroleum sector is as shown in **Figure 2** and described below.

i. Submission and presentation of work programmes and budgets by IOCs

3.13 The operator is required to submit annually to the Cabinet Secretary the annual work programme and budget three months before the beginning of the year, to which they apply.

ii. Review, modification and approval of work programmes and budgets by SDP

3.14 The Cabinet Secretary submits to the contractor, within 30 days of receipt of the annual exploration work programme and budget, suggest modifications and revisions thereof. The contractor considers the inclusion of such suggested modifications and revisions, in light of good international petroleum industry practice and provides the Cabinet Secretary with the exploration work programme and budget which the contractor has adopted.

iii. Implementation of work programmes and budgets by IOCs

3.15 Implementation of work programmes and budgets by IOCs should be as follows:

- a) The contractor implements the approved work programme in the year in which it relates, while continuously submitting progress reports to SDP. The contractor reports in writing to the Cabinet Secretary the progress of petroleum operations according to the following schedule:
 - Within one month of the last day of March, June, September and December covering the previous three months; and
 - Within three months of the last day of December, covering the previous year.
- b) Further, in respect of the period which it covers, the contractor is required to provide:
 - Details of petroleum operations carried out and the factual information obtained;
 - A description of the area in which the contractor has operated;
 - An account of expenditure on petroleum operations in accordance with accounting procedures; and

- A map indicating all boreholes, wells and other petroleum operations.

iv. Submission of annual accounts

3.16 The contractor provides a report of expenditure and receipts under the contract analysed by budget item showing;

- a) Actual expenditure and receipts for the year;
- b) Actual cumulative cost to date;
- c) Latest forecast cumulative cost at the year-end; and
- d) Variations between budget and actual costs and explanations for the variations;

3.17 In addition, the contractor is required to submit a cost recovery statement containing the following information;

- a) Recoverable petroleum costs carried forward from the previous quarter, if any;
- b) Recoverable petroleum costs incurred and paid during the quarter;
- c) Total recoverable petroleum costs for the quarter;
- d) Quantity and value of cost oil taken and separately disposed of by the contractor for the quarter;
- e) Amount of petroleum recovered for the quarter;
- f) Amount of recoverable petroleum costs to be carried forward into the next quarter, if any; and
- g) Value of the Government's share of production taken by the contractor.

v. Audit of books of accounts of International Oil Companies

vi. The Government is required to audit of the books and accounts of the IOCs within two (2) calendar years of the period to which they relate, and complete that audit within one (1) calendar year. In the absence of an audit within two (2) calendar years or in the absence of notice to the contractor of a discrepancy in the books and accounts within three (3) calendar years of the period to which the audit relates, the contractor's books and **accounts** shall be deemed correct.

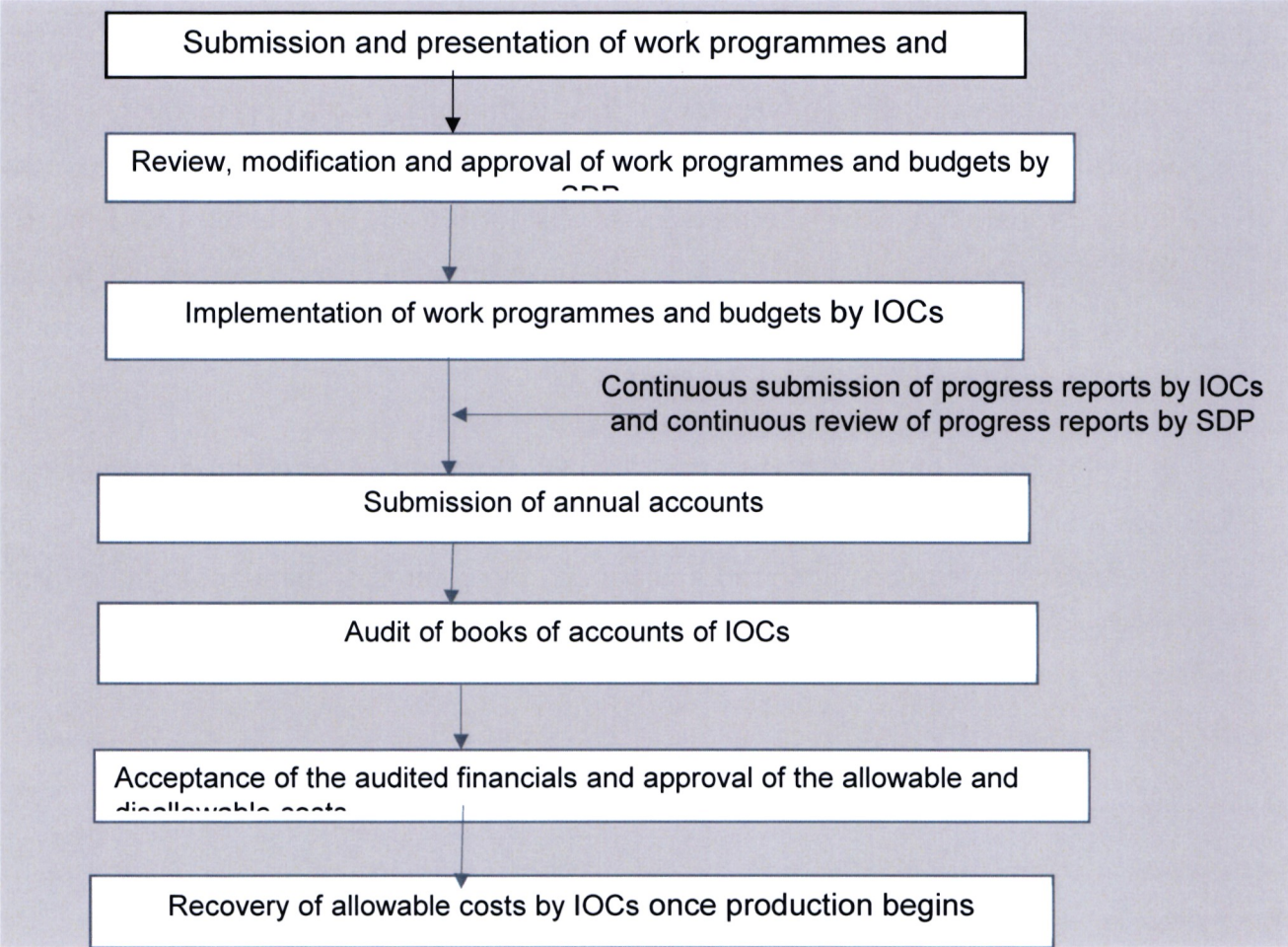
vii. Acceptance of the audited financials and approval of the allowable and disallowable costs.

3.18 For cost recovery purposes, SDP is required to decide on the allowable and disallowable costs from the statements provided by the Oil Companies and a cost recovery audit. The Government contracted a consortium of consultants (a joint venture between Swale House Partners Inc, Rosa, Correira & Associates, SROC, S.A, Radon Law Offices and RES4DEV Consulting Inc.) in 2018 to undertake an audit of recoverable cost by Tullow Oil BV in respect of block 10BB and 13T for the years 2017 and 2018. The report was completed and submitted to the Ministry.

viii. Recovery of costs by International Oil Companies, once production begins

3.19 Once production begins, the contractor recovers allowable petroleum costs, in respect of all petroleum operations, incurred and paid by the contractor pursuant to the provisions of the contract.

Figure 2 : Process Description for Monitoring Costs in the Petroleum Sector



Source: Audit team review of documents on cost monitoring and interviews with relevant staff involved in cost monitoring

CHAPTER 4: FINDINGS OF THE AUDIT

- 4.1 Before the discovery of commercially viable oil, the country had a policy of encouraging exploration, with a liberal policy of attracting investors in the sector. However, after the discovery, the government made a policy shift, by aligning the sector for the development stage. A new legal framework, contained in the Petroleum Act, 2019, has been enacted to guide the sector in the future and to ensure maximum returns to the citizens from the production and sale of oil. Further, the Government, together with stakeholders such as the World Bank, has established linkages to develop technical capacities in the sector.
- 4.2 The audit found that the State Department for Petroleum was developing systems to enhance monitoring of costs in the petroleum sector. However, SDP was still not well prepared to monitor costs and operations in the petroleum sector. The detailed findings are as discussed below.

I. Inadequacies in Submission, Review and Approval of Work Programmes, Budgets and Progress Reports

a) Implementation of unapproved work programmes and budgets

- 4.3 According to Appendix "B", of the Production Sharing Contract section 3.2.1, the operator shall submit annually to the Cabinet Secretary, the annual work programme and budget three months before the beginning of the year to which they apply.
- 4.4 Documentary review indicated that Tullow Oil submitted their work programmes and budgets late. As shown on **Table 1**, submission was done five months late in all the years under review.

Table 1: Dates of presentation and approval of work programmes and budgets from Tullow to the State Department for Petroleum

Year	PSC Requirement date	Date of presentation	Date of approval	Period of Delay for presentation and approval
2012	September 2011	-	-	
2013	September 2012	20/02/2013	28/02/2013	Five months
2014	September 2013	26/02/2014	-	Five months
2015	September 2014	24/02/2015	24/02/2015	Five months
2016	September 2015	15/02/2016	15/02/2016	Five months
2017	September 2016	09/02/2017	09/02/2017	Five months
2018	September 2017	16/02/2017	-	Five months

Key - Indicates no data found

Source: OAG-K analysis of submitted work programmes and budgets

4.5 The late submission was attributed to Tullow Oil awaiting approvals of their work programmes and budgets, by their independent Boards of the Joint Venture Partnership. Consequently, the IOC was implementing unapproved work programmes and incurring expenditure on unapproved budgets. The works done on unapproved budgets and work programmes may later bring about disputes between the IOC and SDP on items and amounts claimed as recoverable.

b) Irregular submission of quarterly progress reports by the International Oil Company

4.6 Section 15 (2) of the PSC states that the contractor shall report in writing, to the Cabinet Secretary the progress of petroleum operations according to the following schedule:

- i. Within one month of the last day of March, June, September and December covering the previous three months; and
- ii. Within three months of the last day of December, covering the previous year.

4.7 Review of correspondence files for block 13T and 10BB revealed that Tullow Oil did not submit their quarterly reports consistently. For the period 2012 to 2019, only 43% and 53% of the reports for blocks 13T and 10BB were submitted, respectively, as shown on **Table 2**. In addition, only 18% of the quarterly reports for each block met the required submission timeframes. There were no follow ups by SDP on the reasons for the delay and non-submission of the quarterly reports. As a result, SDP did not have real time data to incorporate in its decision-making process.

Table 2: Quarterly reports submitted and the dates of submission

Year/Quarter	Q1	Q2	Q3	Q4
BLOCK 13T	*Means report submitted within the required timelines			
2012	28/09/2012	28/09/2012	-	-
2013	-	-	-	-
2014	-	06/08/2014	-	-
2015	26/09/2016	-	27/10/2015*	-
2016	-	-	31/10/2016*	31/01/2017*
2017	-	-	-	08/06/2018
2018	25/07/2018	-	31/10/2018*	-
2019	22/05/2019	13/08/2019	30/10/2019*	30/01/2020*
BLOCK 10BB	*Means report submitted within the required timelines			
2012	28/09/2012	28/09/2012	-	-
2013	-	-	-	-
2014	-	06/08/2014	-	-
2015	Not dated but submitted	Not dated but submitted	27/10/2015*	Not dated but submitted
2016	-	-	31/10/2016*	31/01/2017*
2017	-	-	-	08/06/2018
2018	25/07/2018	Not dated but submitted	31/10/2018*	-
2019	22/05/2019	13/08/2019	30/10/2019*	30/01/2020*

Key “-” indicates no data found “*” indicates quarterly reports submitted within the required timeframes

Source: OAG-K analysis of SDP and Tullow Oil correspondences regarding quarterly reports

c) SDP did not carry out reviews on submitted work programmes, budgets and actual expenditure

- 4.8 According to Section 18 (3) of the Petroleum (Exploration and Development), Act. revised Edition 2012, the Cabinet Secretary may submit to the contractor, within 30 days of the receipt of the annual exploration work programme and budget, suggest modifications and revisions thereof. The contractor shall consider the inclusion of such suggested modifications and revisions, in light of good international petroleum industry practice and shall provide the Cabinet Secretary with the exploration work programme and budget, which the contractor has adopted.
- 4.9 There was no evidence in the correspondence files indicating suggested modifications or revisions on the work programmes and budgets from SDP to Tullow Oil. The work programmes and budgets were approved on the same day when oral presentations were made as shown on **Table 3**. This is an indication that sufficient time was not allocated for reviews of the same.
- 4.10 There were variances between budgeted and actual expenditure, however, no queries were made by SDP on the same. Neither was there communication from Tullow Oil to SDP requesting for approval of the modified budgets, except for inclusion of the Early Oil Pilot Scheme in the budget.

Table 3: No time allowed for review of work programmes and budgets

Year	Date of presentation	Date of approval
BLOCK 10BB AND 13T		
2012	-	-
2013	20/02/2013	28/02/2013
2014	26/02/2014	-
2015	24/02/2015	24/02/2015
2016	15/02/2016	15/02/2016
2017	09/02/2017	09/02/2017
2018	16/02/2017	

Key “-” indicates no data found

Source: OAG analysis of correspondence between SDP and Tullow Oil

- 4.11 Interviews with SDP staff indicated that lack of reviews of the work programmes and budget was attributed to shortage of technical staff as well as lack of standard operating procedures detailing how to receive, review and approve work programmes and budgets.
- 4.12 Implementation of budgets and work programmes that have not been reviewed may lead to IOCs incurring unnecessary expenditure that might eventually reduce the amount of revenue share to the government. This is by items in the un-reviewed work programmes and budgets increasing cost recoverable amounts, which would otherwise not have been approved, if SDP had reviewed the work programmes and budgets.

II. The State Department for Petroleum was Developing Systems to Enhance Monitoring the Activities of International Oil Companies

a) The State Department for Petroleum was developing a commercial database to facilitate monitoring the activities of International Oil Companies

- 4.13 Best practice requires that there is need to have a centralised database to allow for easy access of information among regulating agencies in the petroleum sector. A database allows for a systematic way of collecting commercial data from International Oil Companies to assist monitoring of compliance to the existing Production Sharing Contracts terms and conditions.
- 4.14 As at the time of the audit, SDP was in the process of setting up a database to store petroleum data. Implementation of the database started in May 2019 and was expected to go live in October 2020. The database once fully implemented will allow for analysis of various variables for each block, over the period of operation. The database will be useful for purposes of cost recovery audits, which are quite comprehensive as they involve massive data. SDP will also be in a position to use the available data for identification of areas to focus on during monitoring of petroleum costs.

b) Inadequate technical staff to monitor costs in the petroleum sector

4.15 According to SDP's July 2020 authorized staff establishment, the department was supposed to have 171 staff. Documentary review of the staff establishment revealed that SDP had only 34 technical staff who had a vast area to cover. For SDP to carry out effective cost recovery audits, it requires to have sufficient technical staff as detailed in **Table 4**. However, SDP has been making efforts to fill in the vacant positions. Documentary review indicated that as at July 2020, the Human Resources Department was in the process of recruiting 46 new staff.

Table 4: Staff Establishment for the State Department for Petroleum

Designation	Approved establishment	Current in post	Variance
Technical Personnel	21	6	15
Petroleum Geologist Personnel	22	5	17
Petroleum Geophysicist Personnel	22	3	19
Petroleum Geochemist Personnel	22	0	22
Petroleum Engineers	17	0	17
Petroleum Technologist	34	2	32
Chemical Engineers	5	0	5
Mechanical Engineers	5	0	5
Environmental Compliance Personnel	5	0	5
Petroleum Economist	5	0	5
Petroleum Audit Personnel	6	0	6
Petroleum Finance Personnel	2	0	2
Petroleum Communications Personnel	3	0	3
Petroleum Legal Personnel	2	0	2

Source: OAG-K analysis of SDP's staff establishment and technical staff in post

4.16 The SDP has not been able to effectively monitor costs in the petroleum sector due to lack of the required expertise at the department. This might lead to IOCs recovering non-

allowable costs that would have otherwise not been recovered had monitoring been carried out. Ultimately, this will reduce the amount of government share from revenues generated from the oil resources.

c) Cost recovery statements were not detailed and were inconsistently submitted

4.17 According to the Production Sharing Contract, Section 3.3.2 of the Accounting Procedures, cost recovery statements should be submitted on a quarterly basis and should contain information on; recoverable cost brought forward from the previous quarter, petroleum costs incurred and paid in the quarter and total recoverable petroleum costs carried forward to the next quarter.

4.18 Blocks 10BB and 13T, owned by Tullow Oil, have been in operation since 2007 and 2008, respectively. Despite the requirement to submit cost recovery statements quarterly, documentary review revealed that Tullow Oil submitted cost recovery statements for the first time in September 2016, covering the period from quarter one 2011 to quarter two 2016. In 2017 and 2018, there were instances of late and non-submission of quarterly statements, as shown on **Table 4**. Further, documentary review revealed that cost recovery statements submitted did not have a breakdown of the expenditure incurred.

Table 5: Submission of quarterly cost recovery statement

Year/Quarter	Q1	Q2	Q3	Q4
BLOCK 13T				
2016	-	28/09/2016	28/10/2016*	31/01/2017*
2017	28/04/2017*	01/08/2017	30/10/2017*	27/04/2018
2018	25/05/2018	31/07/2018*	25/10/2018*	28/01/2019*
BLOCK 10BB				
2016	-	28/09/2016	28/10/2016*	31/01/2017*
2017	28/04/2017	01/08/2017	30/10/2017*	27/04/2018
2018	25/05/2018	31/07/2018*	25/10/2018	28/01/2019*

**Submitted within the required timeframe*

Source: OAG-K analysis of cost recovery statements for Blocks 13T and 10BB

- 4.19 There was neither evidence of SDP following up with Tullow Oil for timely submission of cost recovery statements nor requests for detailed statements to be submitted. This was attributed to the fact that SDP did not have personnel with the knowledge and skills required to review cost recovery statements. Further, SDP did not have a checklist detailing the format in which the statements were to be submitted. Therefore, the statements were received and filed with no review and no feedback to Tullow Oil.
- 4.20 Consequently, SDP did not have a breakdown of accumulated recoverable costs. Therefore, SDP could not identify non-allowable costs or inconsistencies in a timely manner. In the event of a dispute, SDP will not have a reference point due to lack a breakdown of costs.
- 4.21 However, it was observed that SDP had contracted a consultant to conduct an exercise on recoverable costs, for the period between 2010 to 2018, based on agreed upon procedures.

d) The State Department for Petroleum had not conducted audits on the books and accounts of the International Oil Company

- 4.22 Section 27(1) of the Petroleum (Exploration and Development), Act. revised Edition 2012, states that the contractor shall recover petroleum costs, in respect of all petroleum operations, incurred and paid by the contractor pursuant to the provisions of the contract and duly entered in the contractor's books of account. Further, Section 30 (3&4) of the Petroleum Act requires that the Government may audit the books and accounts of the IOCs within two calendar years, of the period to which they relate, and shall complete that audit within one calendar year. In the absence of an audit within two calendar years or in the absence of notice to the contractor of a discrepancy in the books and accounts within three calendar years of the period to which the audit relates, the contractor's books and accounts shall be deemed correct.
- 4.23 As at the time of the audit, SDP had not carried out any audit on the books of accounts of the IOC. Due to the lapse in the period of time required in the law for audits, for periods

earlier than 2016, the books and accounts of the IOC might be deemed correct, as per the records of the IOC. Failure to conduct timely audits denies the Government an opportunity to disallow disallowable costs and might lead to the Government not getting its rightful share of profit oil once production begins.

III. The State Department for Petroleum had a Draft Memorandum of Understanding with the Kenya Revenue Authority on Oil and Gas Activities in Kenya

- 4.24 There are two departments at the Kenya Revenue Authority (KRA) that deal with extractive industries; Customs and the Domestic Taxes Department. As at the time of the audit, the departments were dealing with exemption of Value Added Tax (VAT), Pay as You Earn tax and Withholding tax. KRA has an online system for receipt of self-assessment tax returns. For tax purposes, KRA had accumulated self-assessment tax returns for Tullow as a company operating in Kenya.
- 4.25 As at the time of the audit, no framework had been put in place by the State Department for Petroleum for the Kenya Revenue Authority to be involved in cost recovery audits, to provide expert advice on tax related claims. However, as at July 2020, SDP had a draft Memorandum of Understanding on to collaborate with KRA, on oil and gas activities in Kenya. SDP had shared the draft Memorandum of Understanding with KRA and was awaiting feedback. In addition, the Government has enacted the Petroleum Act, 2019 which, provides for the Commissioner General, KRA, or an authorised representative to be member of the National Upstream Petroleum Advisory Committee. This will enhance collaboration between the State Department for Petroleum and the Kenya Revenue Authority.
- 4.26 Further, to ensure collaboration in oil and gas activities among all agencies, the government and the World Bank through the Kenya Petroleum Technical Assistance Programme (KEPTAP) has been conducting trainings and stakeholder engagements. Consequently, KRA, SDP, the National Treasury, the Office of the Auditor General, the

Attorney General's Office and the Ministry of Trade and Industrialization have had various capacity building workshops and trainings in the petroleum sector.

- 4.27 Once the Memorandum of Understanding is finalized and implemented, it will address the risk of non-recoverable tax related claims being approved by SDP due to lack of expertise on tax related matters, which are rather complex in the petroleum sector.

IV. Inadequate Monitoring and Evaluation of the Operations of International Oil Companies

- 4.28 Section 5 (c) of the Petroleum (Exploration and Development), Act. revised Edition 2012 states that the Minister (now Cabinet Secretary) shall supervise petroleum operations carried out under a petroleum agreement. Information gathered from SDP revealed that monitoring of information relating to costs incurred by IOCs is rarely carried out. There has also been no evaluation carried out on operations of Tullow Oil B.V. The department provided two monitoring reports that were not comprehensive on all the operations of Tullow Oil B.V.
- 4.29 Interviews revealed that there were no systems or standard operating procedures in place to guide the frequency and methodology of how monitoring and evaluation should be carried out and reported. Further, SDP did not have a specific budget line for monitoring of costs in the petroleum sector. The budget for monitoring was derived from a vote head that had line items for pre-feasibility, feasibility, appraisal studies and project supervision. This made it difficult to establish exactly how much was budgeted and used in monitoring activities of the IOC.
- 4.30 Lack of standard operating procedures and a specific budget line for monitoring activities resulted to minimal monitoring of IOC's activities. Consequently, the Government might not be able to verify the authenticity of costs incurred by IOCs, due to lack of real time monitoring.

CHAPTER 5: CONCLUSIONS

- 5.1 The Government had identified gaps in the petroleum legal framework and put in place laws to move the country forward from the exploration to the development stage with the enactment of a legal regime of the Energy Act. 2019 and the Petroleum Act. 2019.. The Act. created the Energy and Petroleum Regulatory Authority (EPRA). The Authority will be the energy sector regulatory agency responsible for economic and technical regulation of the petroleum sub sectors, cost recovery audits among other functions. However, more effort needs to be put to ensure that Kenya accrues maximum benefit from its petroleum reserves as standardised formats of reporting. Failure by the Government to institute standardised measures for monitoring costs in the petroleum sector will reduce the government share of profit oil and the reserves may deplete before the country benefits from the resource. Countries in Africa that did not put in place proper measures have not benefited from their petroleum resources, with a large proportion of their citizens still living in abject poverty, what is commonly referred to as a resource curse.
- 5.2 Arising from the audit, it was evident that SDP had not put in place a standardised system to monitor costs incurred by IOCs under the PSCs. As at the time of the audit, SDP did not have a checklist to verify particulars submitted by IOCs leading to submission of work programmes, budgets and progress reports that were not comprehensive. There was lack of follow up by SDP on timely submission leading to late and inconsistent submission of the same. Further, no reviews were done on the submitted work programmes, budgets and progress reports.
- 5.3 It was established that SDP was in the process of developing systems for receipt and storage of data on cost claims from IOCs. The systems will enhance the tracking, review and analysis of the cost claims.
- 5.4 SDP lacked technical staff to review cost claims, therefore, posing a risk of non-recoverable costs being recovered by IOCs. Further, cost recovery statements were submitted inconsistently and were not detailed.

5.5 There was lack of coordination and synergy between SDP and KRA to ensure involvement of KRA during cost recovery audit, for expert advice on tax relate matters. However, as at the time of the audit, SDP had developed a Memorandum of Understanding on how to collaborate with KRA on tax related matters.

CHAPTER 6: RECOMMENDATIONS

- 6.1 In view of the findings and conclusion of this audit, the Auditor- General proposes the following recommendations for implementation by the State Department of Petroleum. This is aimed at improving the monitoring of costs in the Petroleum sector, to ensure that the Government gets its rightful share of profit oil, once production begins.
- 6.2 To ensure timely submission of work programmes, budgets and progress reports, the State Department for Petroleum should:
- i. Consider aligning its submission timelines for work programmes, budgets and progress reports with the meeting timeframes of the Joint Venture Partnerships. This will ensure that Tullow Oil B.V does not implement unapproved work programmes and budgets.
 - ii. Ensure that they have the required technical staff to carry out reviews on submitted work programmes and budgets.
 - iii. Develop standard operating procedures detailing the system of receipt for submission, review and follow up of work programmes, budgets and progress reports. This will ensure timely receipt, thorough review and feedback to International Oil Companies.
- 6.3 To ensure that there are systems in place for review and approval of cost claims from International Oil Companies, the State Department for Petroleum should;
- i. Fast track the finalization and implementation of the database for collection and storage of petroleum data. This will ensure that there are standardised procedures on how petroleum data should be stored for ease of review and access of data for monitoring costs in the petroleum sector.

- ii. Ensure that they have the required technical staff to carry out cost recovery audits. This will ensure that cost recovery audits are carried in a timely manner and non-allowable costs are not approved for recovery purposes.
 - iii. Develop a checklist for receipt of submitted cost recovery statements to ensure that the statements have all the required details.
 - iv. Develop timeframes within which follow up for submission of cost recovery statements should be made. This will ensure submission of all cost recovery statements, for timely audits of the statements.
 - v. Fast track the finalization, signing and implementation of the Memorandum of Understanding with the Kenya Revenue Authority (KRA) on how to collaborate on oil and gas activities in Kenya. This will ensure that KRA is involved during cost recovery audits, to provide expert advice on tax related matters.
- 6.4 To ensure efficient monitoring of the activities of International Oil Companies, the State Department for Petroleum should develop standard operating procedures on how monitoring and evaluation should be carried out. In addition, the department should prioritize monitoring of costs in the petroleum sector. This will ensure that the department has up to date information on the activities of International Oil Companies, for decision making purposes and timely corrective action.

APPENDICES

Appendix 1: Detailed Audit Criteria

- i. According to Section 18 (1 & 2) of the Petroleum (Exploration and Development), Act. revised Edition 2012 (1) The contractor shall submit and orally present to the Cabinet Secretary one month after the effective date, a detailed statement of the exploration work programme and budget for the first contract year; (2) The contractor shall submit and orally present to the Cabinet Secretary three months before the end of each contract year, a detailed statement of the exploration work programme and budget for the next contract year.
- ii. According to Section 18(3) of the Petroleum (Exploration and Development), Act. revised Edition 2012, the Cabinet Secretary may submit to the contractor, within 30 days of the receipt of the annual exploration work programme and budget, suggest modifications and revisions thereof. The contractor shall consider the inclusion of such suggested modifications and revisions in light of good international petroleum industry practice and shall provide the Cabinet Secretary with the exploration work programme and budget which the contractor has adopted.
- iii. According to Clause 15 of the signed PSCs for blocks 10BB and 13T, the IOCs are required to prepare and submit reports to SDP.
- iv. Section 27(1) of the Petroleum (Exploration and Development), Act. revised Edition 2012, states that the contractor shall recover the petroleum costs, in respect of all petroleum operations, incurred and paid by the contractor pursuant to the provisions of the contract and duly entered in the contractor's books of account.
- v. Section 30 (3&4) of the Petroleum (Exploration and Development), Act. revised Edition 2012 requires that the Government may audit the books and accounts of the IOCs within two calendar years of the period to which they relate and shall complete that

audit within one calendar year. In the absence of an audit within two calendar years or in the absence of notice to the contractor of a discrepancy in the books and accounts within three calendar years of the period to which the audit relates the contractor's books and accounts shall be deemed correct.

- vi. Section 5 (c) of the Petroleum (Exploration and Development), Act, revised Edition 2012, states that the Minister (now Cabinet Secretary) shall supervise petroleum operations carried out under a petroleum agreement.

Appendix "B" of the Petroleum (Exploration and Development), Act, Chapter 308, Revised Edition, 2012

PART 1

Accounting Obligations of the Contractor

1.2.1 The contractor shall maintain financial accounts necessary to record in reasonable detail the transactions relating to petroleum operations, which shall be prepared in accordance with the generally accepted standards of international petroleum industry, as more particularly, but not exclusively set out in this accounting procedure.

1.2.2 The contractor shall provide the Government with description in accounting classifications and the contractor shall use such classification when preparing its accounts

1.2.3 The contractor shall provide details of financial accounts in the form of monthly statements which shall:

- a) reflect all charges and credits related to petroleum operations;

- b) be prepared on accrual basis so that expenditure is recorded as incurred when title to goods passes or when work is executed; and
- c) present the total accounts for the contract area and each development area and the share of each non operator.

Appendix "B" of the Petroleum (Exploration and Development), Act, Revised Edition, 2012

PART III Financial reports to the Minister

3.2 The operator shall submit annually to the Minister (now the Cabinet Secretary) the following.

- 3.2.1 The annual work programme and budget three months before the beginning of the year to which they apply and the budget shall be analysed within exploration programme, evaluation programme, development programme and production programme and show for each major budget item with reasonable detail, the following:-
- a) latest forecast cumulative costs anticipated at the start of the budget year;
 - b) cumulative expenditure anticipated at the end of each quarter of the budget year; and
 - c) expenditure anticipated in the future years to complete the future budget item.

- 3.3.1 A report of expenditure and receipts under the contract analysed by budget item showing: -
- a) actual expenditure and receipts for the quarter in question;
 - b) cumulative costs to date;

c) latest cumulative costs to year end; and

d) variation between budget and actual costs and explanations thereof

3.3.2 A cost recovery statement should be submitted on a quarterly basis and should contain the following information: -

a) Recoverable cost brought forward from the previous quarter.

b) Petroleum costs incurred and paid in the quarter.

c) Total recoverable petroleum costs (carried forward to the next quarter).

Appendix 2: List of Documents Reviewed

Document	Reason for Review
The Petroleum (Exploration and Production) Act, Revised Edition 2012	To understand the rules and regulations governing the petroleum sector.
The Petroleum Act, 2019	To obtain an understanding of what has been repealed as well as the new rules and regulations that will govern petroleum sector.
The Energy Act, 2019	<p>To understand the rules and regulations governing the energy sector.</p> <p>To get an understanding of the functions of the newly created regulatory Authority – The Energy and Petroleum Regulatory Authority.</p>
Production Sharing Contracts	To get an understanding of the contractual agreement and obligations of the parties involved.
Correspondence files	To get an understanding of communication between SDP and Tullow regarding implementation of the contractual terms in the PSCs.

Appendix 3: List of Officers Interviewed

Person's interviewed	Purpose of the interview
Commercial Advisor	To obtain an understanding of IOCs and SDPs operations in relation to monitoring of costs in the petroleum sector.
Internal Auditor	
Head of Accounts	To get an understanding of the sources of funding for monitoring of costs in the petroleum sector.
Head of Finance	To get an understanding of the sources of funding for monitoring of costs in the petroleum sector.
Geologist	To get an understanding of how SDP monitors technical operations relating to costs incurred by IOCs.
Kenya Revenue Authority (KRA) staff in;	To obtain an understanding of the operations of KRA in relation to monitoring of costs in the petroleum sector.
-Petroleum Monitoring Unit	To get an understanding on the level of preparedness of KRA in relation to monitoring costs in the petroleum sector.
-Domestic Taxes Department	To gain an understanding on the level of coordination between SDP and KRA on tax related matters, in monitoring costs in the petroleum sector.
-Income Tax Unit	

Appendix 4: List of Oil Blocks and their Status as at April, 2019

S.NO	BLOCK	OPERATOR	EXECUTION DATE	EFFECTIVE DATE	STATUS
1	L1A	A-Z PETROLEUM	12/1/2011	3/2/2012	Active
2	L3	A-Z PETROLEUM	12/1/2011	3/2/2012	Active
3	L4	ZARARA OIL & GAS	9/3/2008	12/3/2008	Active
4	L6	FAR Ltd	8/23/2002	11/21/2002	Active
5	L11A	ENI EP HOLDINGS	3/30/2009	9/28/2009	Active
6	L11B	ENI EP HOLDINGS	3/30/2009	9/28/2009	Active
7	L12	ENI EP HOLDINGS	3/30/2009	9/28/2009	Active
8	L13	ZARARA OIL & GAS	9/3/2008	12/3/2008	Active
9	L14	LAMU OIL & GAS	7/5/2012	10/5/2012	Active
10	L17/L18	AFREN/EAX/OCTANT			Active
11	L19	RIFT ENERGY	6/21/2012	9/21/2012	Active
12	L20	PACIFIC SEABOARD/MILIO	6/28/2012	9/26/2012	Active
13	L21	ENI EP HOLDINGS	6/29/2012	9/27/2012	Active
14	L23	ENI EP HOLDINGS	6/29/2012	9/27/2012	Active
15	L24	ENI EP HOLDINGS	6/29/2012	9/27/2012	Active
16	1	AFREN/EAX/OCTANT			Active
17	2A	SIMBA ENERGY	8/3/2011	11/3/2011	Active
18	10BA	TULLOW OIL	1/27/2010	4/27/2010	Active
19	10BB	TULLOW OIL	10/25/2007	1/25/2008	Active
20	12A	TULLOW OIL/DELONEX	9/17/2008	12/17/2008	Active
21	12B	TULLOW OIL	2/16/2012	5/16/2012	Active
22	13T	TULLOW OIL	9/17/2008	12/17/2008	Active
23	14T	NOCK	2/15/2010	2/15/2011	Active
24	3AA				Never Licensed
25	3BA				Never Licensed
26	9A				Never Licensed
27	L14A				Never Licensed
28	L19A				Never Licensed
29	L25				Never Licensed
30	L26				Never Licensed
31	L29				Never Licensed

32	L30				Never Licensed
33	L31				Never Licensed
34	1A				Never Licensed
35	2BA				Never Licensed
36	10BAA				Never Licensed
37	10BC				Never Licensed
38	11AA				Never Licensed
39	12AA				Never Licensed
40	12BA				Never Licensed
41	15T				Never Licensed
42	3A	VANOIL	10/16/2007	7/31/2013	Open
43	3B	VANOIL	10/16/2007	7/31/2013	Open
44	10A	TULLOW OIL	10/4/2007	1/4/2008	Open
45	L1B	CAMAC ENERGY	5/10/2012	8/8/2012	Open
46	L2	IMARA ENERGY	5/24/2012	8/24/2012	Open
47	L5	ANADARKO	3/30/2009	9/28/2009	Open
48	L7	ANADARKO	3/30/2009	9/28/2009	Open
49	L8	APACHE	3/16/2011	6/14/2011	Open
50	L9	OPHIR/DOMINION	5/17/2011	8/15/2011	Open
51	L10A	BG HOLDINGS ENERGY	5/17/2011	8/15/2011	Open
52	L10B	BG HOLDINGS ENERGY	5/17/2011	8/15/2011	Open
53	L15	OPHIR/DOMINION	10/5/2011	1/3/2012	Open
54	L16	CAMAC ENERGY	5/10/2012	8/8/2012	Open
55	L22	TOTAL E&P	6/26/2012	9/24/2012	Open
56	L27	CAMAC ENERGY	5/10/2012	8/8/2012	Open
57	L28	CAMAC ENERGY	5/10/2012	8/8/2012	Open
58	2B	TAIPAN RESOURCES/LION PETROLEUM	9/17/2008	12/17/2008	Open
59	11A	ERHC/CEPSA	6/28/2012	9/29/2012	Open
60	11B	ADAMANTINE	5/30/2012	8/27/2012	Open

Appendix 5: PART II – Costs, Expenses, Expenditure and Credits of the Contractor

Subject to the provisions of the contract, the contractor shall bear and pay the following costs and expenses necessary to conduct petroleum operations. Such petroleum costs are recoverable by the contractor in accordance with the provisions of the contract.

2.1. Surface rights

2.1.1. All direct costs necessary to acquire and to maintain surface rights to the contract area when such costs are paid by the contractor according to the provisions of the contract.

2.2. Labour and related costs

2.2.1. Salaries and wages of employees of the operator and its affiliate(s) for portion of their time spent performing management, administrative, legal, accounting, treasury, tax, employee relations, computer services, engineering, geological, geophysical, and all other functions for the benefit of petroleum operation, whether temporarily or permanently assigned to the contract area, as well as the cost of employee benefits, customary allowances and personal expenses incurred under the usual practice of the operator and its affiliate(s) and amounts imposed by governmental authorities, which are applicable to such employees.

2.3. Material

2.3.1. Value of material charged to the accounts contract. The cost of material, equipment and supplies purchased or furnished by the operator for use in petroleum operations shall be charged to the joint account on the basis set forth below. So far as it is reasonably practical and consistent with efficient and economical operations, only such material shall be purchased for or transferred to

the joint property as may be required for immediate use and/or for approved work programmes and the accumulation of surplus stock shall be avoided.

2.3.1.1. Except as otherwise provided in sub-part 2.3.1.2. below, material purchased, leased or rented shall be charged at the actual net cost incurred by the operator. "Net cost" shall include, but shall not be limited to, such items as vendor's invoice price, transportation, duties, fees and applicable taxes less all discounts actually received.

2.3.1.2. Material purchased or transferred from the contractor or its affiliate(s) shall be charged at the prices specified here below:

(a) New material (condition "A") shall be valued at the current international net cost which shall not exceed the price prevailing in normal arm's length transactions on the open market;

(b) Used material (conditions "B", "C" and "D");

(i) material which is in sound and serviceable condition and is suitable for re-use without reconditioning shall be classified as condition "B" and priced at seventy-five per cent (75%) of the current price of new material defined in (a) above;

(ii) material which cannot be classified as condition "B", but which after reconditioning will be further serviceable for its original function shall be classified as condition "C" and priced at fifty percent (50%) of the current price of new material as defined in (a), above. The cost of reconditioning shall be charged to the reconditioned material provided that the value of condition "C" material plus the cost of reconditioning do not exceed the value of condition "B" material;

(iii) material which cannot be classified as condition "B" or condition "C" shall be classified as condition "D" and priced at a value commensurate with its use.

2.3.2. Inventories

2.3.1.1. At reasonable intervals, inventories shall be taken by the operator of all controllable material. The operator shall give 90 days' written notice of intention to take such inventories to allow the Minister (now Cabinet Secretary) and non-operator(s) to be represented when any inventory is taken. Failure of any party to be represented after due notice given shall bind such party to accept the inventory taken by the operator.

2.3.2.2. The operator shall clearly state the principles upon which valuation of the inventory has been based.

2.3.2.3. Whenever there is a sale or change of interest in the joint property, a special inventory may be taken by the operator, provided the seller and/or purchaser of such interest agrees to bear all of the expense thereof. In such cases, both the seller and the purchaser shall be entitled to be represented and shall be governed by the inventory so taken.

2.4. Transportation and employee relocation costs

2.4.1. Transportation of material and other related costs such as origin services, expediting, crating, dock charges, forwarder's charges, surface and air freight, and customs clearance and other destination services.

2.4.2. Transportation of employees as required in the conduct of petroleum operations, including employees of the operator's affiliate(s) whose salaries and wages are chargeable under subparts 2.2.1. and 2.5.2.

2.4.3. Relocation costs of the contract area vicinity of employees permanently or temporarily assigned to petroleum operations. Relocation costs from the contract area vicinity, except when an employee is re-assigned to another location classified as a foreign location by the operator. Such costs include transportation

of employees' families and their personal and household effects and all other relocation costs in accordance with the usual practice of the operator and its affiliate(s).

2.5. Services

2.5.1. The actual costs of contract services, professional consultants, and other services performed by third parties other than services provided by the contractor or its affiliate(s), but the prices paid by the contractor shall not be higher than those generally charged for comparable services.

2.5.2. Costs of technical services such as, but not limited to, engineering, and related data processing, performed by the contractor and its affiliate(s) for the direct benefit of petroleum operations, engineering, and related data processing, performed by the Contractor provided such costs shall not exceed those currently prevailing if performed by third parties in normal arm's length transaction for like services.

2.5.3. Costs of use of equipment and facilities for the direct benefit of the petroleum operations, furnished by contractor or its affiliate(s) at rates commensurate with the cost of ownership, or rental, and the cost of operation thereof, but such rates shall not exceed those currently prevailing in the general vicinity of the contract area in normal arm's length transactions on the open market for like services and equipment.

2.6. Damages and losses to joint property

2.6.1. All costs or expenses necessary for the repair or replacement of joint property resulting from damages or losses incurred by fire, flood, storm, theft, accident, or any other cause, except insofar as those costs and expenses are caused by the wilful misconduct of the operator. The operator shall furnish the Government and non-operator(s) written notice of damages or losses for each damage or loss in

excess of fifty thousand U.S. dollars (U.S. \$50,000) as soon after the loss as practicable.

2.7. Insurance

2.7.1. Premium for insurance required under the contract, provided that a party not participating in such insurance shall not share in the costs unless such insurance is compulsory under the laws of Kenya and provided further, that if such insurance is wholly or partly placed with an affiliate of the contractor such premium shall be recoverable only to the extent generally charged by competitive insurance companies other than an affiliate of the contractor.

2.7.2. Actual expenditure incurred in the settlement of all losses, claims, damages, judgments, and other expenses for the benefit of the petroleum operations.

2.8. Legal Expenses

2.8.1. All costs or expenses of litigation or legal services otherwise necessary or expedient for the protection of the joint property or other interest in the contract area, including, but not limited to, legal counsel's salaries and fees, court costs, cost of investigation or procuring evidence and amounts paid in settlement or satisfaction of any such litigation or claims. These services may be performed by the operator's legal staff or an outside firm as necessary.

2.9. Duties and taxes

2.9.1. All duties, taxes (except taxes based on income), fees, and governmental assessments of every kind and nature, which have been paid by the operator with respect to the contract.

2.10. Offices, camps and miscellaneous facilities

2.10.1. Cost of establishing, maintaining and operating any offices, sub offices, camps, warehouses, housing and other facilities directly serving petroleum operations. The costs shall be allocated to the operations served on an equitable basis.

2.11. General and administrative expenses

2.11.1. This charge shall be made monthly for services of all personnel and offices of the operator and its affiliate(s) outside Kenya and those not otherwise provided herein. It shall include services and related office costs of personnel performing management, administrative, legal, accounting, treasury, tax, employee relations, computer services, purchasing, engineering, geological, geophysical, and all other functions for the direct benefit of petroleum operations.

The charge shall be made as follows- This charge will be at the provisional rate of ...of total costs per month during any period in which exploration operations are being conducted. For the period commencing on the date that the contractor reports a commercial discovery to the Government as required in clause 19(5) of the contract until the contract is terminated the provisional rates shall be ...of total costs per month.

The provisional charges for such costs are based upon operator's cost experience and estimates of costs to be incurred in conduct of the petroleum operations, and are subject to quarterly adjustment as operator's costs indicate are necessary and equitable. Within ninety (90) days following the end of each quarter, the operator shall determine the actual costs incurred in performing such services, and shall charge or credit the joint account for the difference between the actual cost incurred for the quarter and the provisional rate charged during the quarter. On request of the Government or a non-operator, the operator shall make available at

its home offices all supporting documents used for the determination of the charges. Such documents shall include but shall not be limited to time allocation reports prepared by employees providing services described in subpart 2.11.1., cash vouchers supporting cash expenses included in the overhead pool, inter-company billings supporting charges for services provided by operator's affiliates (e.g. building rentals, telecommunications paid by the operator's parent company), summary or impersonalized computer run supporting salaries, wages and employee benefits and other such documents as may be mutually agreed.

2.12. Other expenditure

2.12.1. Other reasonable expenditure not covered or dealt with in the foregoing provisions, which are incurred by the operator and its affiliate(s) for the necessary, proper, economical and efficient conduct of petroleum operations.

2.12.2. Interest incurred on loans raised by the contractor for capital expenditure in petroleum operations under the contract at rates not exceeding prevailing commercial rates may be recoverable as petroleum costs.

2.13. Credits under the contract

The net proceeds of the following transactions will be credited to the accounts under the contract:

- (a) the net proceeds of any insurance or claim in connection with the petroleum operations or any assets charged to the accounts under the contract;
- (b) revenue received from outsiders for the use of property or assets charged to the accounts under the contract;
- (c) any adjustment received by the contractor from the suppliers/manufacturers or their agents in connection with defective equipment or material the cost of which was previously charged by the contractor under the contract;

- (d) rentals, refunds or other credits received by the contractor which apply to any charge which has been made to the accounts under the contract;
- (e) proceeds from all sales of surplus material or assets charged to the account under the contract; and
- (f) the prices originally charged to the accounts under the contract for inventory materials subsequently exported from Kenya.

2.14. No duplication of charges and credits

Notwithstanding any provision to the contrary in this accounting procedure, it is the intention that there shall be no duplication of charges or credits in the accounts under the contract.

Appendix 6: The State Department for Petroleum Response to the Audit Findings

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Par. 4.3	<p>Inadequate review and approval of work programmes, budgets and progress reports</p> <p>Late submission of work programmes and budgets</p>	<p>Most companies do submit their work programmes as stipulated in their respective PSCs. In case of late submission, companies always send requests and those which do not send the request are given letters of demand.</p>	<p>We acknowledge the supporting documents provided by your Office and efforts made to address the weakness observed. However, the evidence provided for deferral of submission of work programmes and budgets was only for the year 2020. However, for the rest of the period under review, we observed that work programmes and budgets were submitted late. Due to the above, our finding as reported, is maintained.</p>
Par. 4.5	<p>The International Oil Company was incurring expenditure on an unapproved budget and implemented an unapproved work programme.</p>	<p>Most companies operating in the country have their work programme and budget approved by SDP before implementation. The old Petroleum (Exploration and Production) Act CAP 308 Section 9 (1) (a) and PSC provisions only required IOCs to present the Work Programme and Budget, but did not expressly require approval by the Minister. This was identified as a gap in the law, which allowed spending on unapproved budget.</p> <p>However, the new Petroleum Act, 2019 clause 27 (5) clearly states that</p>	<p>The action taken to address the weakness in the old Petroleum (Exploration and Production) Act, CAP 308 of allowing expenditure on unapproved work programmes and budgets is commendable. We shall confirm whether the SDP is adhering to the provisions of the new Petroleum Act, 2019 in a future follow up audit. Consequently, our observations as at the time of the audit are retained.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Par. 4.6	Irregular submission of quarterly reports by IOCs	<p>Work Programmes and Budgets should be approved by the Cabinet Secretary. SDP has observed this requirement and is implementing the new Petroleum Act, 2019.</p> <p>With the new Petroleum Act, 2019 now in place, SDP is in the process of developing standards and procedures for proper planning.</p>	<p>We commend SDP for developing standards and procedures for proper planning. This will go a long way in ensuring that IOCs submit quarterly reports regularly as required by the new Petroleum Act, 2019. The Office will verify the completion and implementation during a future follow up audit.</p> <p>Since this is still work in progress, our finding is maintained.</p>
Par. 4.7	<p>Tullow did not submit their quarterly reports consistently and within the required timeframe.</p> <p>Lack of follow up by SDP to ascertain the causes or censure the company for delays.</p>	<p>The IOCs submitted all the quarterly reports, however, cases of late submission were noted.</p> <p>The State Department for Petroleum is in the process of setting up an automated system (PIS) that will ensure consistent submission of reports and will prompt both the IOCs when reports are due.</p>	<p>We acknowledge the additional information, with which we updated our report as indicated on table 2. However, even with the update, we still observed irregular and late submission of quarterly reports.</p> <p>We commend SDP for developing an automated system (PIS) that will ensure consistent submission of reports. The finalization of the actions stated can only be confirmed at a future follow up audit. Since the actions are still work in progress, our finding of the state of affairs as at the time of the audit is retained.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Par. 4.9	No reviews carried out by SDP on submitted work programmes, budgets and actual expenditure.	<p>Work programmes and budgets are presented in physical meetings between SDP and IOCs as stipulated in the PSC clause 18 (1). Reviews are done during such meetings and any modification or amendments proposed in the meetings.</p> <p>Going forward, SDP is drafting detailed regulations and guidelines that will structure review and approval of Work Programmes and Budgets.</p>	<p>The action taken by SDP to develop regulations and guidelines that will structure review and approval of work programmes and budgets is commendable.</p> <p>As reported, work programmes and budgets were approved on the same day they were presented. This definitely did not allow SDP sufficient time to review the work programmes and budgets before approval. Since this was the prevailing state of affairs, the finding as reported is retained.</p> <p>The Office of the Auditor-General will during a follow up audit, check on finalization and implementation of the regulations and guidelines.</p>
Par. 4.10	Variance between budgeted and actual expenditure; no queries were made by SDP nor communication from IOCs requesting approval of modified budgets.	<p>The budgeted cost, for example drilling a well may vary significantly from the initial plan if it is an exploration well or depending on ground conditions during drilling. The variation is normally approved by government.</p> <p>Cases of both positive and negative variances occurred in different financial years. This was attributed to IOCs spending lower than budget due to deferred Exploration Studies and Seismic, deferral of Development</p>	<p>We acknowledge the evidence provided for the request and approval of variation in the work programme and budget for the year 2016. Nevertheless, the documentation is for a variation to include the Early Oil Pilot Scheme, which was a later development. The audit scope was March 2012 to July 2020. Despite there being other variations on work programmes and budgets, documentation for request and approval of the variations was not provided. The finding is therefore retained as reported in our draft audit report.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
		<p>FEED and delays in approval of Pipeline Joint Development Agreement or spend higher due to additional wells and appraisal activities.</p> <p>The Production Sharing Contract clause 18(4) allows the contractor to make changes to annual exploration Work Programmes and Budgets if those changes do not materially affect the original objectives of the exploration Work Programme and Budget.</p> <p>The State Department for Petroleum was aware of the variances as communicated by IOC and approved as evidenced in the attached letters.</p>	
Par. 4.15	<p>The State Department for Petroleum is putting up systems to ensure review of cost claims from IOCs.</p> <p>Inadequate technical staff to monitor costs in the Petroleum sector</p>	<p>The State Department for Petroleum has recently recruited 30 technical staff and currently have adequate staff to monitor petroleum costs.</p>	<p>The effort by SDP to recruit technical staff is commendable. However, as noted in the audit, SDP requires a staff establishment of 171 technical staff, out of which only 34 were in post, leaving a deficit of 137 technical staff. Though we acknowledge the economic environment SDP is operating in, for SDP to effectively achieve its objectives, it is paramount that the staff complement be in place or other measures be put</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Par. 4.17	<p>Cost recovery statements were not detailed and were inconsistently submitted</p>	<p>The State Department for Petroleum had followed up on the issue and wrote to the IOC Tullow Oil to provide detailed cost recovery statements and quarterly reports.</p> <p>The issue of inconsistency and timeliness is one of the key procedural findings in the ongoing Cost Recovery Audit for years 2010-2018.</p>	<p>We acknowledge SDP has identified the weakness and acted towards addressing the gaps. Since approved costs are recoverable, it is imperative that SDP be cautious to avoid instances of non-allowable costs being loaded as recoverable. Our finding remains as reported in the draft report.</p>
Par. 4.19	<p>No evidence of SDP following up on timely submission and detailed statements and lack of a format for cost recovery statement submission.</p>	<p>The Production Sharing Contract clearly provided a breakdown of information to be submitted in a cost recovery statement as per PSC Accounting Procedures clause 3.3.2. However, cost recovery statements provided by IOCs have not been detailed enough. It is an issue that will be addressed going forward.</p> <p>SDP will provide a template for capturing cost going forward and is finalizing an automated planning system that will help guide the IOCs better.</p>	<p>We commend SDP for addressing the identified gap. An assessment of implementation of the action taken to address the current challenge will be verified during a follow up audit. The finding remains as reported in our draft report.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Par. 4.20	<p>The State Department for Petroleum did not have a breakdown of accumulated recoverable costs hence could not identify non allowable costs or inconsistencies.</p>	<p>Review of submitted cost recovery statements has been carried out. SDP issued a legal notice of discrepancies to the operator for audit findings (2010-2018) as provided for the PSCs on the non-allowable costs reported as recoverable costs.</p>	<p>The finding is on the lack of a breakdown of accumulated recoverable costs. As evidenced by the response for Paragraph 4.25, cost recovery statements from IOCs have not been detailed enough. The finding remains as reported.</p>
Par. 4.22	<p>The State Department for Petroleum has not conducted any audit on the book of accounts of the IOC .</p>	<p>The State Department for Petroleum procured a "comprehensive independent audit" with the objective of conducting an audit of petroleum costs in blocks 10 BB & 13T to evaluate whether the expenditures were in line with the contractual obligations, mainly the Accounting Procedures, and thus if acclaimed costs are entitled to cost recovery. The audit of petroleum costs procured is consistent with the audit foreseen in Section 30 of the PSCs and petroleum industry standards. In line with the scope of work, the independent auditor performed the audit of petroleum costs and identified certain expenditures that were not in line with the contractual obligations and those where appropriate audit evidence could not be obtained.</p>	<p>Sec 30 of the Petroleum (Production and Exploration Act) Revised edition, 2012, requires the contractor to maintain books of accounts. It states that the contractor shall keep books and accounts in accordance with the accounting procedure and shall submit to the Minister a statement of those accounts, not more than three (3) months after the end of each calendar year. (2) At the request of the Minister, the contractor shall appoint an independent auditor of international standing, approved by the Government to audit annually the books and accounts of the contractor and report thereon; and the cost of such audit shall be at the charge of the contractor. Though the contractor may be maintaining the books of accounts as required in the Petroleum Act, the books may have been prepared for a different purpose or audience, hence the need for the Government to carry out an independent</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
		<p>A cost-recovery audit, or an audit of the "books and accounts" of a Contractor to evaluate compliance with the PSC is a compliance audit of financial information. A compliance audit of financial information falls under the International Standard on Related Services 4400: Engagements to Perform Agreed Upon Procedures Regarding Financial Information (ISRS 4400), set by the International Auditing and Assurance Standards Board in order to promote quality assurance and consistency in non-assurance engagements. The audits foreseen in Section 30 of the PSCs and in the Petroleum Act 2019 cannot be considered financial statement audits as the audits are for the "books and accounts" of the Contractor, rather than a complete set of financial statements and the accounting methods are governed by the Accounting Procedures in the PSC, rather than a generally accepted accounting standard. As such, an assurance engagement under International Auditing and Assurance</p>	<p>audit as envisioned by the Petroleum Act in Section 30(3&4).</p> <p>Section 30 (3&4) of the Petroleum Act requires that the Government may audit the books and accounts of the IOCs within two (2) calendar years of the period to which they relate, and shall complete that audit within one (1) calendar year. In the absence of an audit within two (2) calendar years or in the absence of notice to the contractor of a discrepancy in the books and accounts within three (3) calendar years of the period to which the audit relates the contractor's books and accounts shall be deemed correct.</p> <p>Section 27(1) of the Petroleum Act, Revised Edition, 2012, states that the contractor shall recover the petroleum costs, in respect of all petroleum operations, incurred and paid by the contractor pursuant to the provisions of the contract and duly entered in the contractor's books of account.</p> <p>Our considered opinion was that the Section envisioned an audit of the books of account for the Cabinet Secretary or Government to certify that the books represent a true and fair view of the operations in the period. This will also give the Government assurance that the recoverable costs as stated in the books and accounts of the contractor are rightful and factual. Failure to carry out an audit on the books and accounts of the</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
	<p>Standards is not appropriate. An Agreed-Upon Procedures engagement, resulting in a Report on Factual Findings, is appropriate and supports the Government's audit rights under the PSCs and the oversight obligations under the Petroleum Act 2019 as well as the Government's ability to support discrepancies noted in the Contractor's books and accounts.</p>		<p>contractor presents a risk of non-allowable or overstated costs being recovered and consequently reducing the share of profit oil due to the government once production begins.</p> <p>Section 27, with respect to sub-clauses 27(1), 27(2) and 27(3), cost oil and profit oil calculations shall be done quarterly on an accumulative basis. To the extent that actual quantities, costs and expenses are not known, provisional estimates of such data based on the adopted annual production work programme and budget under clause 24 shall be used. Within sixty (60) days of the end of each fiscal year, a final calculation of cost oil and profit oil based on actual crude oil production in respect of that fiscal year and recoverable petroleum costs shall be prepared and any necessary adjustments shall be made.</p> <p>(5) The contractor shall be subject to and shall comply with the requirements of the income tax laws in force in Kenya, which impose taxes on or are measured by income or profits.</p> <p>Our considered opinion is that Section 27 relates to accumulation of costs by the operator, while Section 30 is on audit of books of accounts. The finding remains as reported in our draft report.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Par. 4.23	<p>Legality of audits carried out for periods earlier than 2016 are questionable.</p>	<p>Invalidity of Cost Oil Recovery Audit Limitation Clauses</p> <p>Clauses 30(3) and (4) of the Production Sharing Contracts for Blocks 10BB and 13T (the PSCs) attempt to create a limitation of time within which cost recovery audits should be performed by the Government. The PSCs were executed under the Petroleum (Exploration and Production) Act, 1984 (repealed), the Regulations thereafter and the repealed Constitution of Kenya. In early correspondence, Tullow argued that clauses 30(3) and 30(4) had the effect of barring the years 2010 to 2015 (inclusive) from the cost recovery audits. The Ministry, in reply, clarified that clauses 30(3) and 30(4) did not apply and cited provisions of the Petroleum Act, 2019 and the Constitution of Kenya, 2010 supporting its position.</p> <p>Since the execution of the PSCs, the Constitution of Kenya was promulgated on 27 August, 2010. Paragraph 6 of the Sixth Schedule does not save Government's</p>	<p>The comprehensive response from SDP is acknowledged. Further, we acknowledge that SDP has had discussions relating to the effect of this provision.</p> <p>We are however of the opinion that the prevailing Act with which the PSCs were signed had clear timelines within which the audits should have been carried out.</p> <p>The finding remains as reported in our draft report.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
		<p>contractual rights and obligations, which are consistent with the provisions of the Constitution. The saving is made only for Government's contractual rights and obligations, which are consistent with the provisions of the Constitution. Paragraph 6 states "except to the extent that this Constitution expressly provides to the contrary, all rights and obligations, however arising, of the Government or the Republic and subsisting immediately before the effective date shall continue as rights and obligations of the National Government or the Republic under this Constitution". The Constitution expressly provides against the application of clauses 30(3) and (4) of the PSCs.</p> <p>The audits in question were conducted subsequent to the promulgation of the Constitution. The audits were therefore to be conducted in observance with;</p> <ul style="list-style-type: none"> i. The national values and principles of public governance (Article 10). 	

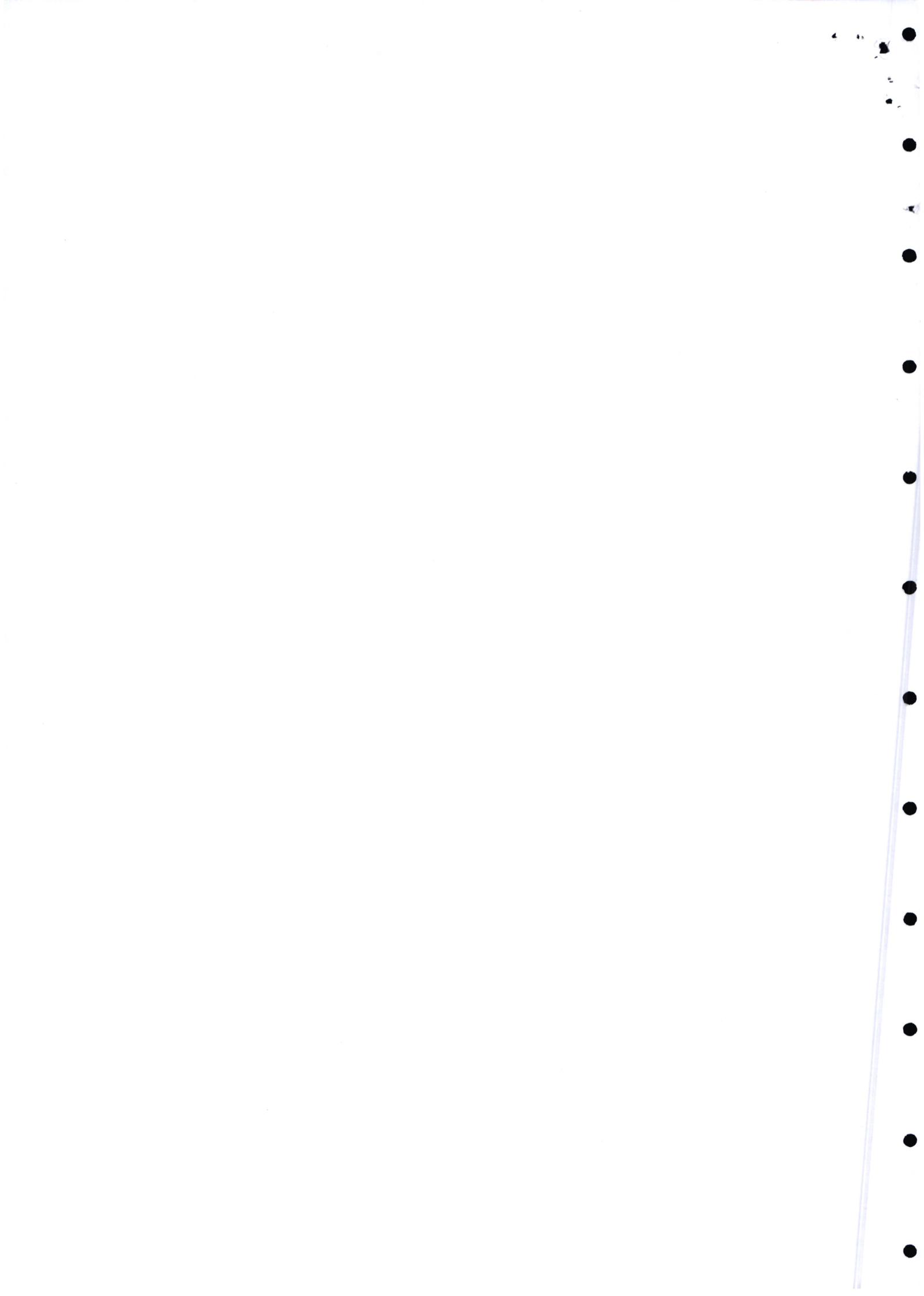
Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
		<ul style="list-style-type: none"> ii. The principles of public finance iii. The individual rights of Kenyans to have the environment protected for their benefit (Article 42) iv. Public land, including all minerals and mineral oils, being vested in the Government in trust for the people of Kenya (Article 62); and v. The requirement for the Government to ensure the sustainable exploration, utilization, management and conservation of natural resources for the benefit of the people of Kenya and to ensure the equitable sharing of such benefit (Article 69). <p>By limiting the Government's right to conduct cost recovery audits, clauses 30 (3) and (4) of the PSCs serve to negate from the finance. These principles are specifically provided for under Article 10 and further particularized under Article 201 read together with Articles 42, 60, 62 and</p>	

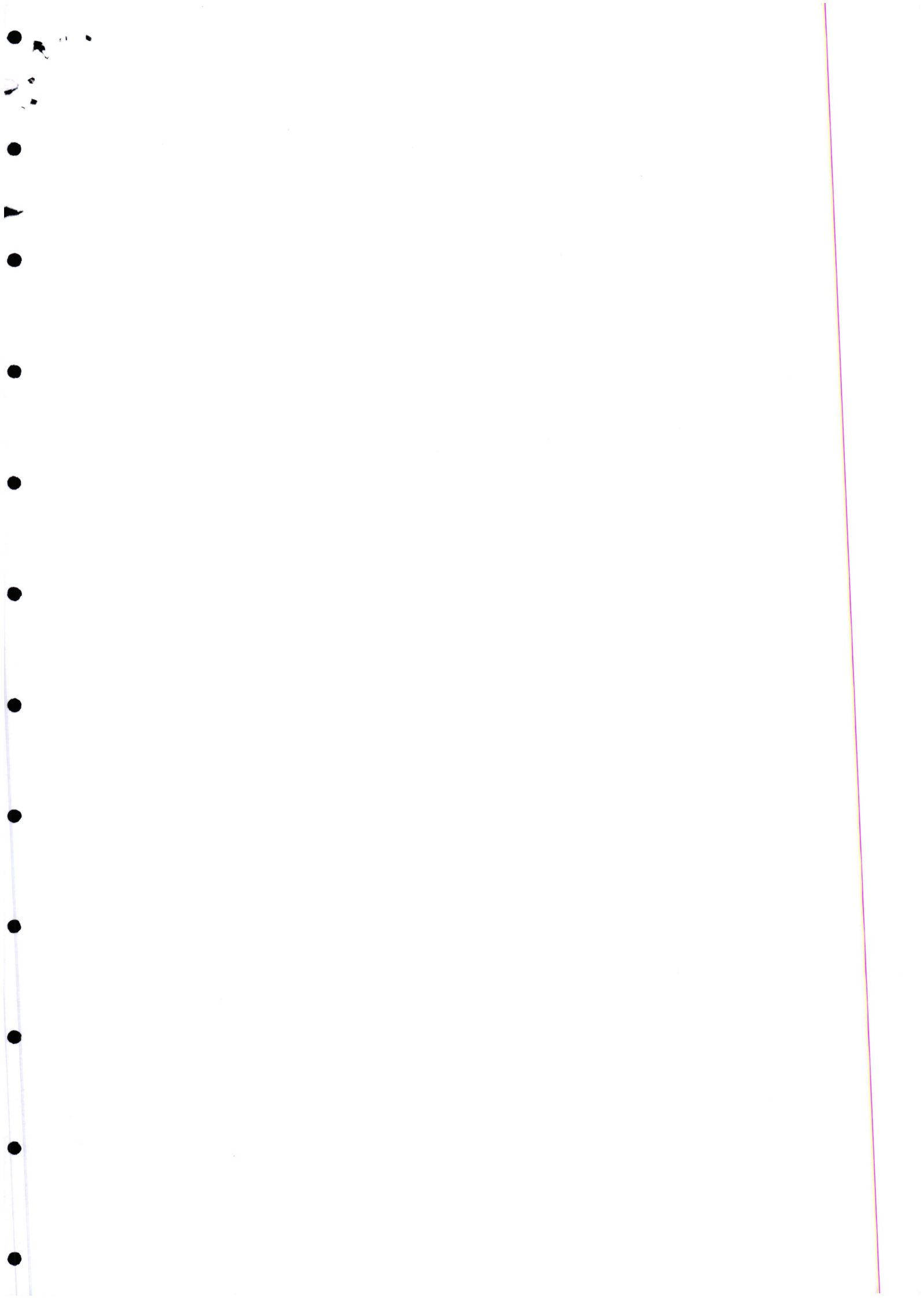
Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
		<p>69. This position is also enshrined in the Public Finance Management Act, 2012. Resultantly, clauses 30(3) and 30 (4) of the PSCs are bound to be invalid for reason of unconstitutionality.</p> <p>In terms of contracts law, there exists several established mitigating factors which discredit clauses 30(3) and 30(4) of the PSCs. These include: (i) fraudulent or negligent conduct; (ii) breach of fiduciary duties; (iii) unjust enrichment and restitution; and, (iv) possible waiver by Tullow.</p> <p>Resultantly, clauses 30(3) and 30(4) of the PSCs are bound to be invalid for these reasons.</p>	
Par. 4.24	<p>The State Department for Petroleum has a draft Memorandum of Understanding with KRA on oil and gas activities in Kenya.</p> <p>No framework in place for KRA to be involved in cost recovery audits so as to provide expert advice on tax related claims.</p>	<p>The State Department for Petroleum has a draft Memorandum of Understanding on how SDP and KRA would collaborate in oil and gas activities in Kenya which has since been shared with KRA.</p> <p>The Ministry of Petroleum and Mining is awaiting feedback from KRA before execution of the MoU. There has been changes in KRA, both at the</p>	<p>The action taken by SDP towards ensuring that there is a framework in place to involve KRA in cost recovery audits is commendable.</p> <p>We shall verify the finalization and implementation of the Memorandum of Understanding during a future follow up audit. As such our finding is retained as in the draft report.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Finding Dropped	<p>Conflicting provisions on cost recoverable items</p> <p>Inconsistencies between PSC provisions and the East African Customs Management Act 2004 on duty exemption while importing motor vehicles and Customs and Excise Act on railway Development Levy.</p> <p>This has led to tax disputes between Tullow Oil and KRA.</p>	<p>Commissioner in charge and Commissioner General's Office, which has contributed to the delay.</p> <p>The Petroleum Act, 2019 provides for the formation of National Upstream Advisory Committee (NUPAC) with KRA as one of the members. NUPAC was inaugurated in May 2020 and provides a legal framework for collaboration.</p>	<p>We concur with the response from SDP on harmonization of the Tax laws and have amended our findings in the report.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
Par. 4.28	<p>Inadequate monitoring and evaluation of IOC operations</p> <p>Monitoring of information relating to costs incurred by IOCs is rarely carried out. No evaluation has been carried out on operations of the IOCs. No monitoring and evaluation reports on IOCs activities. There are no systems or standard operating procedures to guide the frequency and how monitoring and evaluation should be carried out and reported.</p>	<p>Monitoring and evaluation of IOCs operations have been carried out in different phases and is ongoing. E.g. Officers have been attached when: - -Drilling is being undertaken. -Development and review of Field Development Plan. -Community Development projects. -Early Oil Pilot Scheme</p> <p>This has been achieved, despite the lean staff that existed. However, more staff have been recruited to do monitoring going forward.</p> <p>The new Petroleum Act was enacted in 2019, SDP is in the process of preparing and developing policies, regulations and standard operating procedures for monitoring IOCs.</p>	<p>Whereas the Office of the Auditor-General appreciates the effort by SDP to monitor its activities, despite a lean staff, the audit notes that the monitoring is not sufficient for all operations being undertaken by SDP.</p> <p>Further, the report provided for Badada-1 drilling operations relates to Block 2B operated by Lion Petroleum Company which was not within the scope of this audit. The audit scope is for block 13T and 10BB.</p> <p>Finally, auditors had requested for monitoring reports for block 13T and 10BB for the period 2012 to July 2020. The only reports provided were for;</p> <ol style="list-style-type: none"> i. Erut-1 (A vertical exploration well in Block 13T) drilling operations report. ii. A report for September 2019 and 1st October 2019 for tracking transportation of Early Oil. <p>The monitoring reports provided were not sufficient to conclude that SDP has been continually carrying out monitoring of its operations. The finding remains as reported in our draft report.</p>
Par. 4.29	<p>The State Department for Petroleum does not have a</p>	<p>The State Department for Petroleum have a specific budget line under Oil</p>	<p>The copy of the budget provided during the audit was not specific.</p>

Ref. No	Audit Finding	Response by SDP Management	Auditors Comments
	<p data-bbox="327 459 422 1218">specific budget line for monitoring of costs in the petroleum sector.</p>	<p data-bbox="327 1218 422 1937">Exploration and Monitoring Vote 1193100407, which is used for funding monitoring activities.</p> <p data-bbox="327 1218 422 1937">The State Department for Petroleum have a specific budget line under Development budget, Oil Exploration and Monitoring Vote 1193100407, which is used to fund monitoring activities.</p>	<p data-bbox="327 1937 422 2094">The vote head had line item amounts for Pre-feasibility, feasibility, appraisal studies and project supervision. It was noted that the figures for these activities are collective and, therefore, not specific to monitoring only. Auditors requested to be provided with a breakdown to show exactly how much was budgeted and spent on monitoring for each financial year, the information was not provided. In addition; As per the page numbers provided on where to locate budgets allocated for financial years 2013/14, 2014/15 and 2015/16, it was noted that the line items were under the Rural Electrification Program.</p> <p data-bbox="327 1937 422 2094">Therefore, the finding remains as reported in our draft report.</p>





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