The POINT

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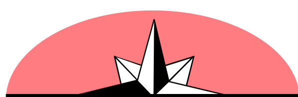
Petroleum Sub-Sector : Debating the Appropriate Policy Framework

While real reforms in the petroleum sub-sector commenced in 1994, the legislative frameworks needed to complement those substantive reforms were delayed. While those legislative reforms are necessary to complement the shifts towards progressive policies, the situation was not complicated when the public realized that despite the fact that the government had lined up a bill (*The Petroleum Bill, 2000*), Hon. Ojode presented an alternative bill. The Institute of Economic Affairs held a public forum on 21st March 2001 and was favoured with presentations from Ms. Mary M'mukindia (General Manager, Petroleum Institute of East Africa) and Mr. Patrick Nyoike (Senior Economist, Ministry of Energy). The Point presents a synthesis of the meeting and a review of the bills.

INSIDE THIS ISSUE

Pre-Liberalization Picture	2
Post -Liberalization Scenario	3
The Petroleum Amendment Bill, 2001	5
Conclusion	8



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For a considerable period of time since the commencement of liberalization of the petroleum sub-sector, it has been argued that new trends and circumstances within the industry required that a revision of the operational law be conducted. This operational law is the Petroleum Act (*Cap 116*) of the laws of Kenya. The Petroleum Act was originally passed as new legislation in 1962 and subsequently amended ten years later.

Given the changes that the petroleum industry has undergone both worldwide and in Kenya since then, it became palpable that there was need to comprehensively review, if not draw a new law altogether.

Petroleum fuels find widespread use in all the productive sectors of the Kenyan economy. Apart from households where energy consumption of petroleum fuels is less than 5%, the other sectors use considerable quantities of the same petroleum fuels find such extensive use in the commercial sector that it constitutes about 63% of the total. In this sector, the only other alternative is electric power. Given the serious electric power shortage last year, the commercial consumption of the petroleum fuels

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must have risen substantially.

On the other hand, Kenya's manufacturing sectors shows the most diversified use of the sources of energy through fuel wood, constitutes more than 43.6% of the sector's total. Besides petroleum at 29.6%, coal provides a significant 9.2% of the total energy used in the manufacturing sector. The transport sector in Kenya is entirely powered by petroleum products. Petroleum provides the agricultural sector with 9.2% of the energy needs.

The energy consumption pattern reveals that besides fuel wood, petroleum is the most widely used energy source in Kenya. It is expected that in the mid to long-term, the extent of petroleum use will rise because of the fact that the present level of use of fuel wood and charcoal is unsustainable. Also due to the inefficiency of the wood extracted fuels, policy must be directed towards the replacement of fuel wood. At the same times, with a growing population, it is unlikely that the forests in Kenya could be replenished in order to meet this demand.

However, the continued impoverishment of the population requires that the policy shift be undertaken urgently to enable the population to progressively switch towards the population extracted fuels such as Liquefied Petroleum Gas (LPG). Such a switch would greatly assist in the conversation of the environment besides placing more efficient and healthier fuels at the disposal of consumers.

The Pre-Liberalization Picture

Before the liberalization of the industry commenced in 1994, the government was heavily involved in determining both the pricing and supply of petroleum products. Then, the Committee for price setting determined the pricing of petroleum products in Kenya. This committee sat regularly to review the prices for given periods and set the prices through the application of a rudimentary price structure which consisted of the landing cost of the product and margin. The representatives of the petroleum marketing companies in Kenya then regularly met the committee to consider put forward their views before the prices were set.

In this situation of government control, the efficiency of the market was not high. Often, the products whose margins were higher such as super had a more assured supply than others. For instance, because kerosene is a product of the refinery process, it was not always possible to produce it in sufficient quantities to meet the high demand since the process of refinery produces specific quantities of the products. So the controlled supply meant that only specified quantities each of the products of the refinery process would be available.

> ***"...given this situation, the overall supply of petroleum products was never assured and shortages were quite common"***

Given this situation, the overall supply of petroleum products was never assured and shortages were quite common. This was because the demand for the products did not necessarily match the proportion that the available crude oil produced.

Because of the price control, the petroleum marketers could not invest in retail stations in the more inaccessible parts of the country since they would not be allowed to factor in the additional costs into the prices. Most of the service and product distribution points were situated in the principal urban areas of Kenya. To that extent therefore, the rural populations of Kenya were doubly disadvantaged in the procurement of petroleum fuels.

The direct result of the relative scarcity of products on one side and the inaccessibility to rural populations of Kenya on the other was the rise of the black market for petroleum products. The pressures of the controlled supply on the one side and prices on the other in the industry

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continued to build up with the result that the market virtually collapsed. As a result, the decision to commence liberalization of the sub-sector was made by the government.

With the passage of time since the liberalization began, the supply of petroleum products has been assured. Not only was the problem of assuring supply solved but also the range of products has been expanded with the right products mix available in the market. The quantitative constraints that the marketers faced on account of the refinery have been resolved too.

The evidence for this is seen in the availability of the right amounts of kerosene and other petroleum products in the market. Further to the assurance of supply and individual product quantities, the widespread black market in petroleum products that had depended on the shortages is virtually wiped out. However, new problems have arisen due to the incomplete deregulation of the market and also because of the new dispensation to move products freely.

It cannot altogether be disputed that the two processes of reform and deregulation of the sub-sector have been of immense value to the economy of the country. However, the momentum to finish off the liberalization process has not fully run its course because there are still anomalies within the sub-sector that require an objective regulatory authority to handle.

The Post -Liberalization Scenario

It has been mentioned herein that the deregulation of the sub-sector in Kenya commenced in 1994. The major thrust of the deregulation was to simultaneously free prices and the supply of petroleum products. The consumer expectation was that the supply of products would improve and that competition between the firms would soon translate into a reduction in prices.

Two main factors have influenced the outcomes of the policy shifts that were undertaken.

1. Market Structure

At the time that the liberalization of the petroleum industry began, international oil companies with subsidiaries in Kenya largely dominated the market. Most of the retail and trade outlets were owned and run by the said companies. Besides the multi-national petroleum marketers were state corporations whose market share was far lower than that of the major international companies. The multi-national corporations based in Kenya controlled well above 80% of the total market. Indeed there was ready admission that the industry was highly concentrated.

The expectation was that liberalization would allow the entry of more players into the market in order to intensify competition. This was to be achieved through the reduction of government influence by lifting price and supply controls thereby making the industry attractive to new investors. As the liberalization and deregulation was going on, the government expressed the willingness to register more foreign and local firms to begin market operations. So while new licenses were issued, few firms actually began meaningful operations. These expectations were not fulfilled because the deregulation did not by itself sufficiently lift the barriers to entry.

@ *Barriers to Entry*

To start with, the petroleum industry has enormous barriers to entry on account of the heavy capital and infrastructural investments required for start-ups. This necessarily puts at a disadvantage the new entrants especially in light of the interest rates that apply to loans. Therefore, this requirement for capital-intensive investment necessarily forms a formidable barrier to market entrants of Kenyan origin and particularly favours corporations with huge capital reserves and those who have high credibility in terms of credit standing.

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@ *Horizontal and Vertical Integration*

The vertical and horizontal integration of the industry also translate into the initial barriers to entry faced by new entrants. The vertical integration is apparent in the character of the industry where the company that bears the brand name usually does the procurement, the refining, distribution and owns the retail facilities as well. Horizontal integration is often more visible at the retail level where the stations are not only owned by the branded company but also that the stations operate under the brand name and are often owned by the company itself. In this way, the marketer has control of most of the supply to its retailers. As a corollary, there is little independence of the retailers and prices are sanctioned by the marketer.

@ *Co-ownership of the Refinery*

Other barriers to entry are merely behavioural and relate to the unique relationship between the firms that operate within the market. It is relevant to take into account the fact that the major oil firms in Kenya are co-owners of the refinery together with the government. The Kenya Petroleum Refinery Limited is 50% owned by the government and the rest of the equity is shared out among the principal petroleum marketing firms.

To that extent therefore, the individual marketing firms have a business relationship with the government and one another as far as the profitability or efficiency of the refinery is concerned. This relationship may be a barrier to entry because new entrants who wish to make use of the facility would have to negotiate terms with real competitors in the market place.

@ *Volumes of Trade*

Secondly, most of those that have begun usually operate only at the retail level. They still rely on the major players as suppliers for their retail outlets. Admittedly, this has intensified the competition between the major players to supply the unbranded retailers in order to retain market share but given the modest volumes of this section of the market, the overall competitive effect is meagre. In sum, the new entrants who are unbranded operate at such small scale and at the retail levels and for this reason have hardly intensified the competition within the industry as a whole.

2. Fiscal Policy

@ *Revenue Maximisation*

Government policy towards taxation of petroleum products is geared towards maximising on earning revenue. The rates are therefore determined by the need for the government to raise revenue from the operations of the industry. This comes from the realisation of the extensive use of petroleum and the ease with which the revenue can be collected since the major players are in the formal sector.

"...even if the prices at the world level were to fall and all other factors remained the same, the reduction in pump prices would not be significant registered"

The success of this reasoning is evident in the fact that government revenue from the taxation on petroleum products has been at 10% or more, a figure that has not changed with liberalization of the sub-sector. Due to the heavy reliance upon the taxation of the petroleum products in revenue generation, even if the prices at the world level were to fall and all other factors remained the same, the reduction in pump prices would not be significant registered.

@ *Redistributive Effects*

Apart from the revenue maximization fiscal approach, the other policy approach is calculated to have a distributive effect. An explicit indication of this pursuit is the differential taxation of particular products in accordance with the supposed incomes of groups that consume those products. The taxation thresholds vary for all the fuels and products generated from the refinement of crude oil.

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@ ***Market Distortion***

For instance, the taxation for the petrol fuels (super and regular) are consistently higher in comparison to diesel oil and kerosene. The basic argument for this is that the consumers have different levels of income and therefore the higher income earners should pay higher levels of tax. Essentially therefore, the more expensive products serve to subsidise the others with the effect that the policy distorts the market.

The Petroleum Amendment Bill, 2001

The Petroleum Amendment Bill, 2001 drafted by Hon. Ojode also proposes a regulatory authority but with some marked differences. The first distinction from the bill discussed above is that the Petroleum Amendment Bill, 2001 is fashioned as an amendment to the incumbent Petroleum Act (***Cap 116***) as opposed to the Petroleum Bill, 2000, which is intended to totally replace the incumbent statute.

The other fundamental difference is that the amendment bill proposes the formation of the Oil Industry Regulatory Board to be headed by the executive director. In pursuit of this, it seeks to insert a ***Section 3A*** into the principal act to establish the Petroleum Board. Professional requirements are that the executive director should have five years experience within the petroleum sector.

Membership to the board comprises of persons with university degrees or equivalents and not less than 5 years practical experience in matters related to petroleum, energy, industry, finance, economics, engineering or law. There is no reason to believe that the market in Kenya cannot operate efficiently without price controls despite the current problems. Instead, the competition authority (Monopolies and Prices Commission) should be empowered through resources and manpower to enable the institution to act in order to halt behaviour that serves to influence prices or where consumers are exploited.

In common with the proposed replacement, the amendment act stipulates under ***Section 3C(1)*** that the Board shall be financed from the Petroleum Development Levy Fund and its budget shall be approved by the Minister of Energy after due consultation with the Minister for Finance.

With a proposed membership of eleven people, the board shall be chaired by an appointee of the minister of energy. It is immediately evident that the constitution of the board was intended to represent wide interests. However, this becomes the bane of the institution because it comprises many interested parties who may not be impartial as industry regulators. In addition, there is no organisation bearing the name of small-scale petroleum dealers and so identification of the representative would be difficult.

Considering that among the proposed functions of the board are to regulate distribution and pricing particularly, it is difficult to expect the objectivity of the members when up to six of the eleven may gain or lose from the decisions concerning prices. For instance, the transporters, the small scale petroleum dealers, the multinational oil companies, and the National Oil Corporation of Kenya (NOCK) all may have an interest in keeping the prices of petroleum at a certain level. It is doubtful therefore to what extent they would deliberate on the board with open and objective minds. As interested persons therefore, it is altogether imprudent to let marketers and consumers to directly determine the prices.

The office of the Executive Director is established by ***Section 3D*** and s/he shall be the secretary to the board and a non-voting member of the same. The licensing functions of the board are reinforced through ***Section 3E(2)*** where it has authority to appoint petroleum licensing officers in consultation with the minister of energy. A subsequent clause provides for the licensing officers to revoke licences on recommendation of

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Figure 1: Energy Consumption in Kenya by Sector in % age

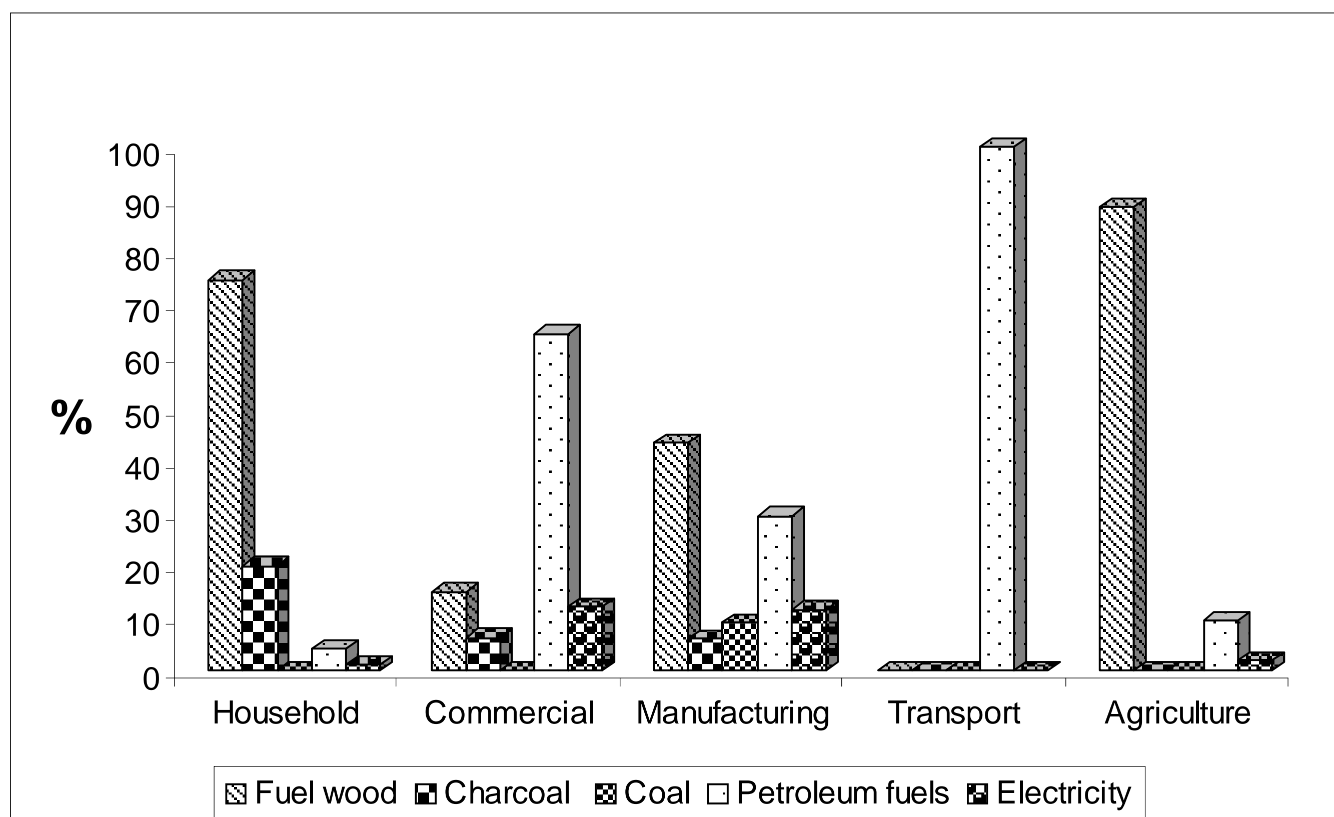

Table 2: World Oil Demand for 2001

(million barrels/day)

	2000	1Q01	2Q01	3Q01	4Q01	**2001**	**Change 2001/00** Volume	%
North America	24.01	24.05	23.91	24.70	24.81	24.37	0.36	1.5
Western Europe	14.97	15.23	14.66	15.10	15.45	15.11	0.14	0.9
OECD Pacific	8.60	9.43	8.06	8.30	8.88	8.66	0.07	0.8
Total OECD	**47.58**	**48.72**	**46.62**	**48.10**	**49.14**	**48.15**	**0.57**	**1.2**
Other Asia	7.31	7.38	7.60	7.55	7.73	7.57	0.25	3.5
Latin America	4.74	4.61	4.84	4.96	4.93	4.84	0.09	2.0
Middle East	4.39	4.38	4.50	4.63	4.50	4.50	0.11	2.5
Africa	2.43	2.52	2.54	2.45	2.56	2.52	0.08	3.3
Total DCs	**18.88**	**18.89**	**19.47**	**19.60**	**19.72**	**19.42**	**0.54**	**2.9**
FSU	3.75	3.70	3.59	3.51	4.08	3.72	-0.03	-1
Other Europe	0.80	0.85	0.81	0.81	0.84	0.83	0.02	3.1
China	4.70	4.89	4.54	5.10	4.91	4.86	0.16	3.5
Total "Other regions"	***9.25***	***9.44***	***8.94***	***9.41***	***9.83***	***9.41***	***0.16***	***1.7***
Total World	**75.71**	**77.05**	**75.03**	**77.11**	**78.69**	**76.97**	**1.26**	**1.7**

Source: OPEC Monthly Oil Market Report -April 2001(P.12 Table 5)

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the board. The practicality of this is in doubt because it does not specify which is the final authority in that revocation since ***Section 3B(1)*** specifically states that the powers for granting licences rest with the board. It should therefore be the board that formally revokes the licences.

Section 3F also establishes the office of petroleum inspectors to enforce the provisions of the bill. The inspectors shall have powers to enter into business premises in order to ascertain compliance with the provisions of the act. The only caveat is that the petroleum inspectors can only enter into premises of a licensee with that licensee's permission. It is not clear what would follow in the case where such permission is refused. ***Section 3B (1) (b)***, specifically states that among the functions of the board will be to regulate and control the prices of petroleum.

While it is also true that the head of the regulatory authority should bear sufficient knowledge and experience of the industry that range of experience within the industry itself must necessarily be balanced against the pragmatic requirements of such a position. The industry is undergoing such monumental changes that insistence upon 15 years experience is tantamount to foreclosure on potential applicants for the position.

So far, Kenya's Petroleum industry has only operated under a controlled regime and under a far from competitive market structure. The insistence upon fifteen years experience means by the proposed Petroleum Bill, 2000, that only a person with experience in the major firms and one who has also worked under the hitherto uncompetitive environment is likely to qualify. In terms of qualifications for the role of the officers for the sub-sector's regulatory authority, the prescriptions of the amendment bill are far more realistic when compared to the Petroleum Bill, 2000.

Price control proposals in this bill appear in ***Section 3H(1)*** which urges petroleum dealers to charge "just and reasonable prices" for products without defining what operational meaning may be attributed to these words. ***Section 3H(2)*** goes further to require all licensed dealers in petroleum products to file proposed schedules with the board for approval within twenty days of the bill coming into effect.

Prices may not be changed until the approval of the board for such adjustment is expressly obtained. Besides the transfer of issues that would otherwise be decided by the market to this board whose members as already argued would be quite subjective, the bill further proposes that the intention to raise prices must be communicated to the board twenty days in advance. Such a requirement fails to take account of the fact that the price movements in the market rarely accord public administrators considerable periods for the decisions to be made. This delay is added to by the requirement by ***Section 3H(6)*** which states that after the receipt of the proposals for price adjustment, the board would publish the proposals and allow the public a further ten days for comment.

Notwithstanding the existence of a fairly comprehensive environmental management bill, the bill seeks to establish environmental standards under ***Section 3J*** by detailing the procedures for conducting an environmental impact assessment. Whereas the petroleum sub-sector has the potential to contribute to serious environmental degradation, there is no justification for placing the provisions for the preservation of the environment within the petroleum bill itself. Since an overarching ***Environmental Management and Co-ordination Act*** has been passed in parliament, then that law remains the correct repository for such rules and the penalties for such degradation should ideally lie there. This is important so as to obviate the possibility of conflicts between laws in terms of the offences and the penalties for them.

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Conclusion

If Kenya were to succeed in the elaborate years towards poverty reduction, the quality and quantities of energy consumed would have to increase considerably. By extension therefore, the growth of the petroleum sub-sector will be a key determinant of that success policy and legislative issues governing the industry must be updated to fit the post liberalization scenario and be able to accommodate further growth. Because this sub-sector was liberalized without a regulatory institution and rules, the policy imperative is to create this institution fairly urgently. Prudence demands that an independent institution be created and rules for its work.

> ***"...the policy and legislative intent of providing the most competitive retail price can only be achieved through market competition and not by price control"***

This institution must then address itself to the issue of competition with regard to the removal of entry barriers that have so far allowed for the market concentration. It cannot be over emphasized that a sufficiently competitive market can be achieved and would be more efficient than a price control mechanism. The ensurance of compliance to the standards will be imperative as well.

It should not be dismissed in entirety because it attempts to respond to the concentrated market structure structure that in turn reduces competitive pricing. The policy and legislative intent of providing the most competitive retail price can only be achieved through market competition and not by price control.

With regard to legislation , it is necessary for policy makers and legislators to take to mind the trends affecting the worldwide oil industry. From here, it will be possible to draw out a legislation that responds to those trends and the realities of the domestic market to aid the sub-sector's growth in Kenya. This makes it necessary to draw an entirely new bill in replacement of the current Petroleum Act (***Cap 116***). In terms of a comprehensive review, the proposed ***Petroleum Bill, 2000*** seems to be in line with the sub-sector's requirements.

Still, the ***Petroleum Amendment Bill, 2001*** has more realistic provisions in some respects. Some convergence would seem prudent in order to incorporate the more progressive provisions of both bills in terms of creating a workable regulatory authority for the sub-sector.

A Comprehensive Report of the meeting is available from IEA offices.

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