

LEGAL REGULATION OF THE PRICES OF PETROLEUM PRODUCTS

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DECLARATION

I Kennedy Morara Ontiti do hereby declare that this is my original work and has not been submitted and is not currently being submitted for a degree in any other university.

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 23/11/2012

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DEDICATION

To my Mum, Dad, brother – Henry, sisters - Caroline, Betty, Jacqueline and Gladys whose encouragement and belief in me has given me the strength to walk this journey.

LIST OF ABBREVIATIONS

CFA	-	Collateral Financing Arrangements
ERC	-	Energy Regulatory Commission
KENGEN	-	Kenya Electricity Generating Company Limited
KM	-	Kilometre
KOSF	-	Kipevu Oil Storage Facility
KOT	-	Kipevu Oil Terminal
KPA	-	Kenya Ports Authority
KPC	-	Kenya Pipeline Company Limited
KPLC	-	Kenya Power and Lighting Company Limited
KRA	-	Kenya Revenue Authority
LAPSSET	-	Lamu Port and Lamu-South Sudan-Ethiopia Transport Corridor
LPG	-	Liquefied Petroleum Gas
M ³	-	Metre Cubed
MoU	-	Memorandum of Understanding
MT	-	Metric Tonnes
NEMA	-	National Environmental Management Authority
NOCK	-	National Oil Corporation of Kenya Limited
OMC	-	Oil Marketing Company
OTS	-	Open Tender System
PPM	-	Parts Per Million
PPP	-	Public Private Partnership
SBM	-	Single Buoy Mooring
SOT	-	Shimanzi Oil Terminal
TEAL	-	Tamoil East Africa Limited
TGU	-	Thermal Gasoil Unit
USD	-	United States Dollar

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Local Government Act (Chapter 265 of the Laws of Kenya)

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The Energy (Petroleum Pricing) Regulations, 2010
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CHAPTER 1

LEGAL REGULATION OF THE PRICES OF PETROLEUM PRODUCTS

Are Price Caps the way to go?

1.1 Introduction

The energy sector in Kenya comprises of three main sources of energy. These sources are biomass, electricity, petroleum and petroleum products. Biomass comprises of wood fuel (firewood and charcoal) and agricultural residues¹. While electricity, petroleum and petroleum products are the prime movers of the modern sector of the economy, wood fuel provides energy needs of the traditional sector including rural communities and the urban poor². At the national level, wood fuel and other biomass account for about 68% of the total primary energy consumption, followed by petroleum and petroleum products at 22%, electricity at 9% and others at about less than 1%³. Petroleum and petroleum products are therefore the most important source of commercial energy in Kenya and are mainly used in the transport, commercial and industrial sectors⁴.

Despite the electricity subsector being a liberalised one, the government has maintained a strong grip on the subsector with a controlling interest in the two major players in the subsector, the Kenya Power and Lighting Company (KPLC) where it has a 50.1 % shareholding⁵ and the Kenya Electricity Generating Company (Kengen) where it has a 70 % shareholding⁶.

The petroleum subsector has been left to private players, mainly multinationals, who have continued to operate in a liberalised environment. The government nevertheless has a stake in the petroleum subsector through the National Oil Corporation of Kenya (NOCK) with both upstream and downstream operations and a market share of 5.8 % in the downstream market. It

¹ The National Energy Policy: Sessional Paper No. 4 of 2004 on Energy available at <http://www.afrepren.org/cogen/downloads/SessionalPaperNo.4of2004onenergy%20Kenya.pdf> (Accessed 30th June 2011). 11

² *ibid*, p. 6

³ *ibid*

⁴ Kenya: Integrated Assessment of the Energy Policy; With focuss on the transport and household energy sectors; United Nations Environment Programme Report 2006 p. 12

⁵ Prof. Albert Mumma: The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 20

⁶ *ibid*

is also, through the Kenya Pipeline Company (KPC) in which it holds 100% of the shares⁷, the biggest transporter, bulk storage facility operator and handler of petroleum and petroleum products in Kenya. The government also has a 50% stake in the only refinery in Kenya, the Kenya Petroleum Refineries Limited, with Essar Energy Overseas Limited holding the rest of the shares⁸.

On 14th November, 2008 vide Kenya Gazette Notice No. 10719, the Energy Regulatory Commission established under the Energy Act⁹ with the mandate of regulating the energy sector invited members of the public to submit, within forty days, written comments on the Proposed Regulations in Respect of the Retail Pump Prices of Petroleum Products published along with the invitation. The Regulations proposed a cost based price formula that sought to cap the maximum prices of petroleum products by factoring the cost of import, throughput¹⁰ as well as duties and dictating a fixed gross margin per litre of petroleum products. The formula was intended to control the price per litre of Kerosene, Automotive Diesel, Regular petrol and Super petrol.

The formula met stiff opposition from the industry majors who comprise the multinational petroleum and petroleum products marketing companies comprising companies which include without limitation, Kenya Shell Limited, Total Kenya Limited, KenolKobil and Libya Oil Kenya Limited. The companies argued that introducing price controls, more so on a single commodity (petroleum products) was likely to bring distortions into an otherwise self-regulating market¹¹. Moreover it was their case that such a move would deter investment in the subsector which was already witnessing the exit of major companies like Caltex¹². The companies further argued that safety standards in the subsector would be compromised if the companies were to remain profitable¹³. The proposed regulations were not operationalised.

In the last quarter of the year 2010, the price of Super petrol rose steadily from just about Kenya Shillings 85 per litre to almost Kenya Shillings 95 per litre with the prices of other petroleum

⁷ *Supra* note 5 at 22

⁸ *Supra* note 5 at 21

⁹Section 4 of the Energy Act.

¹⁰ An industry term used to refer to transport and storage of petroleum products.

¹¹ The Companies made written submissions to the Energy Regulatory Commission objecting to the implementation of the Regulations. A summary of their submissions are highlighted in Annex 2 of the Commission Paper on Petroleum Pricing Regulations Stakeholders Forum available at www.erc.go.ke/pricereg.doc accessed on 15th July 2011.

¹² *ibid* Also see R.D. Paterson: In Fuel Price Cap, the devil is in the details; Daily Nation; 16th December 2008. R.D. Paterson is currently the Managing Director of Roy Hauliers, a company engaged in *inter alia* the transportation of petroleum products, and is a former Managing Director of Mobil Oil Kenya Limited (presently Libya Oil Kenya Limited)

¹³ *supra* notes 11 and 12.

products also going up by a significant margin¹⁴. There was public outcry at the escalating cost of petroleum products to a point that the Minister of Finance was summoned by the Parliamentary Committee on Energy to shed light on the government's position with regard to the rising fuel prices¹⁵. The Energy Regulatory Commission on its part blamed the Ministry for not gazetting the Regulations. In its statement titled "Press Statement on Current Levels of Retail Petroleum Prices" issued through its Director General on 24th November 2010, the Energy Regulatory Commission stated in relevant part as follows¹⁶:

"The power of the Commission in making regulations is limited to making recommendations to the Minister. With extensive stakeholder consultations, as required by the Energy Act, ERC drafted regulations for setting the maximum pump prices of three petroleum products namely Petrol, Automotive Diesel and Kerosene. The Commission approved and submitted to the Minister the Proposed Regulations on Petroleum Retail Pricing in April 2009. The proposed regulations include a formula for capping the maximum pump prices after incorporating all prudently incurred cost inputs. These proposed regulations have not been gazetted by the Government and, therefore, there is currently no legal mechanism for enforcing them."

The Permanent Secretary in the Ministry of Energy in an informal meeting with the Parliamentary Committee on Energy undertook to have the Regulations gazetted before the end of the week beginning on Sunday, 28th November, 2010 and ending on Saturday, 4th December 2010. The Regulations were gazetted on Friday, 3rd December 2010¹⁷ and the Energy Regulatory Commission on 15th December 2010, pursuant to regulation 3(3) of those regulations, issued the first set of maximum pump prices of petroleum products.

1.2 Problem Statement

From the foregoing, it is fairly discernible that the implementation of the price formula through the gazettment of the Regulations was inspired by the increasing prices of petroleum products

¹⁴ See Nation Correspondent: Motorists Feel the Pinch of High Fuel Prices: The daily Nation; 16th November 2010 available at <http://www.nation.co.ke/business/news/Motorists%20feel%20the%20pinch%20of%20high%20fuel%20prices%20/-/1006/1054682/-/wvsv2d/-/index.html> accessed on 3rd November 2011.

¹⁵ See Alphonse Shiundu: Uhuru skips Mps meeting on fuel prices: The daily Nation; 25th November 2010 available at <http://www.nation.co.ke/News/Uhuru+skips+MPs+meeting+on+fuel+prices/-/1056/1060176/-/item/0/-/hwijomz/-/index.html> accessed on 3rd November 2011

¹⁶ Page 1 of the Press Statement available at <http://www.erc.go.ke/erc/Regulations/PRESS%20STATEMENT%20ON%20PETROLEUM%20PRICES%2024112010.pdf> accessed on 3rd November 2011

¹⁷ The Energy (Petroleum Pricing) Regulations, 2010: Kenya Gazette Supplement No. 88 dated 3rd December 2010: Legal Notice No. 196

and is not the result of a well planned and thought out strategy to address the issue of high petroleum product prices. Indeed, one is inclined to take the view that had the prices not soared to the levels that they did in late 2010, the Regulations would have continued to gather dust on the shelves in the offices of the Ministry of Energy. This study therefore seeks to prove that despite the prices of petroleum products being driven by the international prices of crude oil, the inefficiencies, challenges and bottlenecks associated with the legal and regulatory regime as well as the players in the petroleum subsector are a significant contributor to the high petroleum products prices. It also seeks to prove that the enactment of the Competition Act (Act No. 12 of 2010) dispenses with the need for the government to continue regulating the prices of petroleum products.

1.3 Objectives

The general objective of the study is to create an understanding of the legal and regulatory regime governing the process of importation, supply, distribution and sale of petroleum products as well as the different players and/or stakeholders in the petroleum subsector.

The study has two specific objectives as follows:

1. To analyse the inefficiencies and challenges posed by that legal and regulatory regime as well as inefficiencies, challenges and bottlenecks attributable to the players and/or stakeholders in the petroleum sub-sector as regards the importation, supply, distribution and sale of petroleum products and their contribution, if any, to the soaring petroleum products prices.
2. To make conclusions on the efficacy of the Energy (Petroleum Pricing) Regulations, 2010 in taming the escalating petroleum product prices in light of the inefficiencies, challenges and bottlenecks in the sub-sector and to make recommendations.

1.4 Research Questions

While addressing these areas of concern, the study attempts to get answers to the following fundamental research questions:

1. What is the legal and regulatory framework surrounding the importation, supply, distribution and sale of petroleum products in Kenya?
2. What are the inefficiencies and challenges posed by that legal and regulatory regime and what is their contribution, if any, to the soaring prices of petroleum products?
3. Who are the players and/or stakeholders in the petroleum subsector and how, if any, do they contribute to the soaring petroleum product prices?
4. Is the price formula a viable solution to the rising petroleum product prices?

1.5 Hypothesis

The study will test the following hypotheses:

1. That the legal and regulatory framework governing the petroleum subsector is not designed to enhance efficiency and ensure that the consumer gets a competitive price for petroleum products.
2. That in addition to the legal and regulatory framework governing the petroleum subsector, various players and/or stakeholders in the subsector through their *inter alia* operational inefficiencies, contribute one way or the other to the high petroleum products prices.
3. That the price control regulations are not a good solution to the soaring petroleum products prices.

1.6 Justification

The study is justified in three ways.

Firstly, the price formula having been operationalized on 3rd December, 2010 is a fairly recent development. The possibility that its operationalization was the product of public outcry over escalating fuel prices suggests that its likely adverse effects may not have been given the required consideration.

Secondly, the petroleum subsector is critical to the economy of the country since any problem in the subsector is likely to have a ripple effect on all other sectors many of which are powered by or depend on the petroleum subsector. This study can inform a policy change by proposing

other ways of addressing escalating petroleum product prices and other problems facing the petroleum subsector.

Thirdly, in the author's opinion as supported by his literature review and as further highlighted in the limitations herein, recent studies done critically analysing not only the current legal and regulatory framework governing the petroleum subsector but also the players and stakeholders in the petroleum subsector have been fairly scanty. Most of the literature relates to the period before the enactment of the Energy Act, 2006. Owing to the dynamic nature of the subsector, there is a genuine need to take a critical look at the legal and regulatory framework governing the subsector in light of the Energy (Petroleum Pricing) Regulations, 2010. That dynamism is evident in the fact that even as the author tries to piece together this study, major changes with the potential of rendering some portions of the study obsolete are happening in the subsector. Such changes include *inter alia* the following:

1. With the passage of a new constitution in 2010, the Ministry of Energy has prepared a draft energy policy in line with the new constitution for review by among others, industry players and stakeholders. In addition, plans are underway to review the energy laws in Kenya including the Energy Act, 2006.
2. The Kenya Petroleum Refineries Limited (KPRL) is scheduled to cease operating as a toll refinery and to begin operating as a merchant refinery before the third quarter of 2012.
3. The Energy Regulatory Commission (ERC) on 23rd December 2011, 30th December 2011 and 18th May 2012 published draft regulations seeking public comments on the same¹⁸:
4. In Early March 2012 Prime Minister Melles Zenawi of Ethiopia, President Salva Kiir of South Sudan, President of Kenya - Mwai Kibaki and Prime Minister of Kenya - Raila Odinga formally inaugurated the construction of a modern port in Lamu, an oil refinery, an oil pipeline, a modern railway line and a super highway to connect South Sudan, Kenya and Ethiopia. The Lamu Port and Southern Sudan-Ethiopia Transport corridor (LAPSSET) as it is known is a transport and infrastructure project that when complete will be the country's second transport corridor. Kenya's other transport corridor is the Mombasa port and Mombasa - Uganda transport corridor that passes through Nairobi and much of the Northern Rift.

¹⁸ Vide Gazette Notices Numbers 6446, 16447, 16448, 16449, 16646, 16647, 16648 and 16649 respectively.

5. On 26th March 2012, President Mwai Kibaki announced that a British company, Tullow Oil Plc, given the rights to explore for crude oil in block 10BB in Turkana had struck oil. However, the announcement did not confirm whether or not the oil discovered was of commercial quantities¹⁹.

1.7 Theoretical Framework

This study will rely largely on the pass-through theory. The theory entails the passing through of costs incurred in the procurement, supply, distribution and retail stages to the end consumer of products.

Generally the study adopts the view that in addressing the high petroleum products prices, the government should not focus on capping the margins oil companies make but should seek ways of bringing down the costs incurred in the procurement, supply, distribution and retail of petroleum products through enactment of proper laws and infrastructure development. This is so because even if one puts a cap on the prices of petroleum products, for as long as the mechanism that has been put in place in arriving at that capped price is one that factors in the costs incurred in procuring, supplying, distributing and retailing petroleum products, one is unlikely to achieve the intended results (fair/low prices) if the costs of procurement, supply, distribution and retail are high due to inefficiencies, challenges and bottlenecks. High petroleum products prices resulting from high profit margins by oil companies can be tamed through strong competition laws.

1.8 Methodology

This study is mainly theoretical and as such, will majorly be desk-based. It will therefore largely rely on library research. Books on Energy law will be consulted. The Energy Act as well as regulations made under it will also be consulted.

Owing to the novel nature of the topic, opinions of experts in newspapers, periodicals and journals will be relied upon heavily. The opinions of business writers may be referred to as well. Research reports and papers published by the Energy Regulatory Commission will provide an in-depth understanding of the operations in the petroleum subsector.

¹⁹ "Kenya Strikes Oil" The Daily Nation, 27th March 2012, Headline Story

The internet will also be a valuable tool for researching this topic.

The author will also, through interviews, rely on information from employees of various companies and institutions who have worked in the subsector for a significant number of years and therefore have a wealth of experience in relation to the subject matter.

1.9 Limitations

Limited local publications in the area of petroleum is a major limitation. As earlier noted, most of the published material on the legal and regulatory framework governing the petroleum subsector relates to the era prior to the enactment of the Energy Act, 2006.

Another limitation relates to the confidential nature of valuable information in various documents and agreements. While the author may, by virtue of his position as a legal counsel in one of the petroleum marketing companies in Kenya, have access to valuable information such as agreements relating to the practice and operations in the subsector, the same is in most if not all cases considered confidential and subject to a confidentiality clause. Where the author seeks to rely on such information in this study, the identity of the parties to the documents or agreements shall be withheld. Even without disclosing the identity of parties to the documents or agreements, this still remains a major limitation due to the fact that some players in the subsector are monopolies so that for instance a reference to an agreement for transportation by pipeline would rightly imply that one of the parties is KPC. Similarly reference to a crude processing agreement would rightly imply that one of the parties is KPRL.

Closely related to the foregoing limitation is the unwillingness of employees of various companies and institutions who have worked in the subsector for a significant number of years to be cited as having given certain information especially where such information is considered sensitive. This is for the obvious reason that they need to continue receiving income in the form of a salary even after the publication of this study. Where the author relies on such information, only the title and not the name of the employee or the company he works for shall be disclosed. Like with the confidential documents and agreements this still remains a major limitation when relying on information from employees working for the monopolies in the subsector.

Another limitation that has been briefly addressed in the “Justification” part of this proposal is the dynamic nature of the subsector and the changes currently being witnessed in the subsector. As already noted by the author, this dynamism and changes currently happening in the subsector may render certain portions of the study obsolete and this may happen even before the study is completed. The following must therefore be noted:

1. This is a study that must start and be completed within set timelines as proposed in the Plan to Completion outlined in this proposal. It is therefore given that the petroleum subsector will still be experiencing changes, be they fundamental or minor, with regard to the legal and regulatory framework as well as the practice and operations of the subsector even as this study is conducted and completed.
2. While the author will make every attempt to incorporate or at least take note of the changes in the legal and regulatory framework as well as the practice and operations in the petroleum subsector, it may not be feasible to revise approved chapters of this study in line with such changes due to the ripple effect that the revision will have on subsequent chapters and possibly create a need to review the entire study. Where the author cannot incorporate a change due to the impact it will have on the very basis of this study, the author shall take note of it and recommend further study and analysis in the future by those who will rely on this study.

1.10 Literature Review

As already noted in the research methodology, a large cross section of sources of information will be consulted for useful information on this area. The author will at this point attempt to group these sources of information into various genres and accord a mention to those he has already looked at and found to be key to this study. It must be noted however that the sources of information reviewed herein are not at all exhaustive of all the sources of information that will be referred to in the study and in the formulation of the final research report. Some of these materials will now be accorded a special mention as follows:

1.10.1 Text books

The author has not come across any book published in the recent past on the laws and regulations in the Kenyan petroleum subsector. There exists a real possibility that none may have

been published more so in relation to the period after the petroleum products price control regime.

An in-depth analysis of some of the players and stakeholders in the energy subsector is to be found in the book “Energy Utilities and Institutions in Africa”²⁰. Owing to the fact that the book was published in 1996, some of the information published therein, such as the ownership structure of KPRL, has changed. However, for NOCK and KPC, the ownership structure has largely remained unchanged. The book is a source of useful information for anyone seeking to understand the history and ideas behind the establishment or incorporation of KPRL, NOCK and KPC.

Another book that examines the issues surrounding Kenya’s petroleum subsector is titled “Petroleum Marketing In Africa: *Issues in Pricing, Taxation and Investment*”²¹. Being economists, the authors have examined these issues under the following headings:

1. Kenya’s petroleum subsector in context;
2. Petroleum pricing and taxation issues;
3. Financing and marketing issues and policy; and
4. Conclusions and policy recommendations.

The book also does a comparative analysis of the petroleum subsector in Ethiopia and Kenya.

The book examines the subsector during a period when the prices of petroleum and petroleum products were liberalised and notes a major weakness in the Restrictive Trade Practises, Monopolies and Price Control Act (Chapter 504 of the Laws of Kenya) to be that a price offence is considered committed only if there exists, or has existed, an arrangement among sellers in the market to influence prices. It notes that in the petroleum subsector, although a cartel does not seem to exist, an oligopolistic structure has supported cartel like market behaviour in determining product prices since the advent of market liberalisation.

“Petroleum Market Structure and Pricing Following Deregulation”²² is a fairly small book of only thirty pages. The book interrogates issues surrounding the pricing of petroleum products after

²⁰ G. Elfaki Ali, I.A.R. Elgizouli, B.A. Okech, P.M. Nyoike and M.R. Bhagavan: *Energy Utilities and Institutions in Africa: African Energy Policy Research Network*, 1996

²¹ Stephen Karekezi, Bereket Kebede, Patrick Nyoike, Benjamin Okech, Timothy Ranja: *Petroleum Marketing in Africa; Issues in Pricing, Taxation and Investment*, Africa Energy Policy Research Network, 1999

October 1994 when Kenya moved from a price controlled regime to a liberalised regime. Like in the book “Petroleum Marketing In Africa: *Issues in Pricing, Taxation and Investment*”²³, the authors are economists, and have therefore looked at most of the issues from an economic lens. They nevertheless take the view that the legal and regulatory framework is inadequate to oversee a smooth and efficient administration of the petroleum industry. They further take the view that there is need to institutionalise functions of the free market to promote standards and effective regulation in the petroleum industry. The book notes that the legal and regulatory framework after liberalisation was insufficient to curb uncompetitive trade practises in the petroleum subsector. Like their fellow economists Patrick Nyoike and Benjamin Okech in the book “Petroleum Marketing In Africa: *Issues in Pricing, Taxation and Investment*”²⁴, they propose a review of the Restrictive Trade Practises, Monopolies and Price Control Act (Chapter 504 of the Laws of Kenya).

1.10.2 Academic, Business and General writings

Prof. Albert Mumma²⁵ is perhaps one of the few if not the only author who has made a most recent and significant attempt at describing the legal and regulatory framework governing the petroleum subsector as well as the practice and operations of the subsector. His contribution is particularly significant for the fact that for one seeking to comment on whether price controls are the preferred means in addressing the issue of rising petroleum prices, one needs to get an appreciation of the policy, law and institutional framework governing the subsector and his publication gives that necessary overview of the subsector. His publication generally starts by stating what may appear to many as an obvious fact that the demand for petroleum products in Kenya is met through importation of refined petroleum products and refining of crude oil at KPRL. Both the crude oil and the refined petroleum products are imported through the open tender system. It is noted in the publication that The Energy (Petroleum Pricing) Regulations, 2010 are a measure taken by the government to address the high fuel prices. Other measures noted in the publication include:

- (a) Reduction of excise duty by 30% and 20% on Kerosene and Diesel respectively.
- (b) Further, zero rating of tax on kerosene as effected in June 2011.

²² John Mecheo and John Omiti: Petroleum Market Structure and Pricing Following Deregulation; Institute of Policy Research and Analysis, 2003

²³ *Supra* note 21

²⁴ *Supra* note 21

²⁵ Prof. Albert Mumma: The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; Published as a teaching aid for the course, Legal Regulation of Power and Energy Sectors – University of Nairobi Course Code GPR 654, 2011

- (c) The intention by the Government to have 90 days strategic petroleum stock reserves maintained by the NOCK.
- (d) The fact that NOCK is currently operating 80 petrol stations country-wide (5.8% of the market share) and seeks to acquire, by 2013, seventy additional retail stations to increase its market share to 15% so as to effectively moderate domestic prices.

The publication also gives an overview of some of the players and stakeholders in the petroleum subsector, their ownership structure as well as some of the challenges they face in conducting their core work. As such, the publication is useful in providing current information on NOCK, KPC and KPRL that is lacking in the text books already discussed above.

In 2008 when the Energy Regulatory Commission came up with the price control formula, some experts in the subsector commented on the likely effects of the formula. One of those who commented was Bob Peterson a former Managing Director of Mobil Oil Kenya as well as Chairman of the Petroleum Institute of East Africa. In his article²⁶, Bob paints a gloomy picture of price controls citing six reasons why a price formula is not the solution to the escalating fuel prices. He concludes that the formula ought not be implemented.

Another consultant on petroleum issues thought otherwise. George Wachira²⁷ took the view that the if the formula is used, it will earn consumer trust and protect the oil industry from unfounded outrage.

1.11 Chapter Breakdown

The thesis is intended to be reported in four thematic chapters as follows:

1. This proposal or research design will serve as the introductory chapter of the research paper and it will therefore be **chapter one**.
2. **Chapter two** will seek to create an understanding of the legal and regulatory regime governing the process of importation, supply, distribution and sale of petroleum products as well as the different players and/or stakeholders in the petroleum subsector.

²⁶ Bob Paterson; In Fuel Price Cap, The Devil is in the Details, Daily Nation, December 16, 2008

²⁷George Wachira; Lets Implement the Oil Price Formular, Nation Business Daily November 24, 2010

3. **Chapter three** will analyse the inefficiencies and challenges posed by that legal and regulatory regime as well as inefficiencies, challenges and bottlenecks attributable to the players and/or stakeholders in the petroleum sub-sector as regards the importation, supply, distribution and sale of petroleum products and their contribution to the soaring petroleum products prices.
4. **Chapter four** will comprise of a conclusion and recommendations.

1.12 Plan to Completion

The author plans to complete the writing of the thesis by 30th June 2012. It is intended that each chapter will take a maximum of two weeks to finalise.

1.13 Conclusion

The foregoing captures the plan on how the author intends to conduct this study. With the issue of price controls in the petroleum sub-sector being fairly current, the author is optimistic that this study will spark debate on the legal and regulatory regime governing the pricing of petroleum and petroleum products. It is hoped that this debate will help the country move towards a legal and regulatory dispensation that strikes the correct balance between attracting investment into the subsector and protecting the rights of consumers of petroleum and petroleum products.

commencement of this Act shall be deemed to have been done under the provisions of this Act;⁶

Also preserved under the Energy Act are all statutory instruments issued under the Electric Power Act, 1997 and the Petroleum Act⁷. Statutory instruments were prior to the Enactment of the Energy Act issued by the Electricity Regulatory Board⁸, as the electricity subsector regulator, and the Minister of Energy, as the petroleum subsector regulator⁹. With the establishment of the ERC under the Energy Act as the energy sector regulator¹⁰, all statutory instruments issued prior to the enactment of the Energy Act were to remain in force and be deemed as having been issued by the ERC under the Energy Act¹¹.

Since the focus of this paper is the petroleum subsector, no attempt will be made to interrogate the rules, regulations and statutory instruments made under the Electric Power Act, 1997. The author will analyse the Energy Act, the rules, regulations and statutory instruments made thereunder insofar as the petroleum subsector is concerned as well as the rules, regulations and statutory instruments made under the Petroleum Act now deemed to have been made under the Energy Act.

2.2.1 The Energy Act, 2006

The Energy Act provides the legal framework for electrical energy¹², petroleum and natural gas as well as renewable energy¹³. Petroleum and natural gas is provided for in Part IV of the Act.

2.2.1.1 Licensing

Section 80 of the Act provides for the licensing of petroleum businesses¹⁴ while section 90¹⁵ provides for the issuance of construction permits for construction of any petroleum pipeline, refinery, bulk storage facility, bulk liquefied petroleum gas facility, natural gas facility or retail dispensing site. Section 80 further requires that vehicles to be used in the transportation of petroleum must have valid petroleum permits issued under the Act and the drivers of such vehicles must be certified under the Act¹⁶. In issuing a permit under section 90 of the Act, the

⁶ Section 123 (2) (a) of the Energy Act.

⁷ Section 123 (2) (b) of the Energy Act.

⁸ Established under section 119 of the Electric Power Act, 1997 (Chapter 116 of the Laws of Kenya - *Repealed*)

⁹ Pursuant to section 4 of the Petroleum Act (Act No. 11 of 1997 - *Repealed*)

¹⁰ Section 4 of the Energy Act.

¹¹ Section 123 (2) (b) of the Energy Act.

¹² Part III of the Energy Act.

¹³ Part V of the Energy Act.

¹⁴ It requires one to get a licence before engaging in any business of importation, refining, exportation, wholesale, retail, storage or transportation of petroleum.

¹⁵ Section 90(1) provides that the application must be made in writing while section 90(2) specifies what the application must contain.

¹⁶ Section 80 (3) to (4) of the Energy Act.

ERC will take into account relevant factors including *inter alia* compliance with the Environmental Management and Co-ordination Act, 1999 and, in particular, the report of the Environmental (Impact Assessment and Audit) Regulations, 2003, the Physical Planning Act, 1996, the Local Government Act and any other relevant legislation¹⁷.

Emergency pipeline works are excluded from the requirement for a permit provided that the owner of the works informs the ERC in writing of the works executed attaching copies of detailed construction drawings as soon as is reasonably practicable but in any event not later than sixty days after the works have commenced or have been executed¹⁸. Also excluded from the requirement for a permit are pipeline constructions within a storage depot, a pipeline facility or a refinery¹⁹.

The ERC reserves the right to suspend or revoke a construction permit if any term or condition thereof has not been complied with within the prescribed period²⁰ and to reinstate the same if satisfied that the reasons for the revocation or suspension no longer exist²¹. The foregoing notwithstanding, permits issued under the Act cease to have effect if execution of the works has not commenced at the expiry of twelve months from the date on which the permit was granted, or at the expiration of any extended period which the Commission may allow²².

The foregoing sections of the Energy Act set the stage for the enactment of licensing regulations²³. The present position is that ERC issues licences for importation, refining, exportation, wholesale, storage and transportation of petroleum products²⁴ while district commissioners are ERC licensing agents for the retail of petroleum products²⁵. Licences issued under the Act are valid for one year²⁶ and applications for renewal must be lodged at least thirty days before expiry²⁷ otherwise a penalty will be levied²⁸. While an application for renewal made under the Act thirty days before expiry of the current licence remains unconsidered, it is not

¹⁷ Section 91 of the Energy Act.

¹⁸ Section 92(a) of the Energy Act.

¹⁹ Section 92(b) of the Energy Act.

²⁰ Section 93(1) of the Energy Act.

²¹ Section 93(3) of the Energy Act.

²² Section 94 of the Energy Act.

²³ Most of these licensing regulations are in draft form and have been listed in paragraph 1.7 of Chapter 1. These draft regulations will be discussed briefly later in this Chapter.

²⁴ See "Application Form for a Petroleum Business Licence (Except LPG)" available at <http://www.erc.go.ke/erc/forms/PETROLEUM%20LICENCE%20APPLICATION%20FORM.pdf> (Accessed 14th May 2012)

²⁵ Rule 5(1) of the Petroleum Rules

²⁶ Section 82(3) of the Energy Act.

²⁷ Section 82(4) of the Energy Act.

²⁸ Section 82(7) of the Energy Act.

prohibited to continue conducting a petroleum business even after the expiry of the current licence²⁹. The ERC is required by law to maintain a register of licences and permits that is open for inspection to the public upon payment of the prescribed fee³⁰ but the police, public officers acting in the course of duty and commission employees may inspect the register without paying any fee³¹.

The ERC or its licensing agent has power to amend³² or revoke³³ a licence or permit issued under the Act and any licence or permit issued must be displayed prominently³⁴. The ERC also has power under section 86 of the Act to issue a duplicate licence where a licence is lost, defaced or destroyed³⁵. A licence issued under the Act cannot be transferred without the consent of the ERC³⁶ and situations in which a transfer may be permitted are provided for under the Act³⁷.

A person aggrieved by a decision of the ERC or a licensing agent in refusing to renew or grant a licence, revoking a licence, imposing conditions on a licence or refusing to replace or amend a licence may appeal to the tribunal established under section 108 of the Act in the case of an appeal against the ERC or the ERC in case of an appeal against a licensing agent³⁸.

The Energy Act also provides for the maintenance of minimum operational stocks⁴⁰ as well as for the power of the Minister to provide strategic petroleum stocks⁴¹. These provisions form the basis for the enactment of the Energy (Minimum Operational Stock) Regulations, 2008⁴² and the Energy (Petroleum Strategic Stock) Regulations, 2008⁴³ which will be discussed later in this chapter. Section 99 of the Act requires all persons engaged in petroleum business to comply with environment, health and safety standards and further requires persons engaged in the

²⁹ Section 82(6) of the Energy Act.

³⁰ Section 88 of the Energy Act. The particulars to be recorded in such register are provided for in section 88 (1).

³¹ Section 88(3) of the Energy Act.

³² Section 83 of the Energy Act. Amendment is subject to the applicant so requesting and where the ERC or the licensing agent refuses to amend a licence, the ERC or licensing agent must give the applicant, if the applicant so requests, the reasons in writing for the refusal.

³³ Section 85 of the Energy Act. Failure to display the licence or permit prominently is an offence that attracts a fine not exceeding one hundred thousand shillings for each day or part thereof that the licence is not displayed.

³⁴ Section 84 of the Energy Act. The ERC or licensing agent can revoke a licence or permit where the undertaking or the execution of the works related thereto has not commenced at the expiry of twenty-four months from the date on which the licence or permit was granted. It can also revoke a licence or permit where it is satisfied that the licensee is either willfully or negligently not operating in accordance with the terms and conditions of the licence, permit or the provisions of this Act or any regulations thereunder or where the licensee is adjudged bankrupt.

³⁵ This is upon application by the licensee.

³⁶ Section 87(1) of the Energy Act.

³⁷ Section 87(2) of the Energy Act.

³⁸ Section 89 of the Energy Act.

⁴⁰ Section 96 of the Energy Act.

⁴¹ Section 97 of the Energy Act.

⁴² L.N. No. 44 of 2008

⁴³ L.N. No. 43 of 2008

transportation of petroleum and petroleum products to have an oil clean-up plan⁴⁴. In the event of a fire, explosion, oil spill, injury or fatality, the transporter of petroleum is required to clean up the polluted or damaged environment, at his own expense, to the satisfaction of the ERC and other relevant authorities⁴⁵. Local authorities are required pursuant to section 99 of the Act to set aside places exclusively reserved for parking of petroleum tanker vehicles and failure to do this amounts to an offence that attracts a fine of fifty thousand shillings for each day or part thereof that the offence continues⁴⁶.

2.2.1.2 Offences

Section 100 of the Energy Act prescribes offences relating to petroleum undertakings. It makes it an offence for an importer not to maintain minimum operational stocks⁴⁷. It also makes it an offence for an owner or operator of a refinery, pipeline, bulk liquefied petroleum gas or natural gas facility, service station, filling station or storage depot or transporter of petroleum to fail to institute appropriate environmental, health or safety control measures⁴⁸. A pipeline, retail dispensing site, storage depot, refinery or bulk liquefied petroleum gas or natural gas facility owner also commits an offence if he contravenes the provisions of the Act or regulations made under the Act⁴⁹.

Section 101(1) of the Act makes it an offence for the owner or master of a ship carrying petroleum not to give notice to port authorities upon entering a port as may be required by regulations made under the Act. The Petroleum Rules are deemed to be regulations made under the Act and provide for written notice to be issued whenever possible by the owner or agent for a petroleum ship to the port manager 24 hours in advance of the expected arrival of any such ship⁵⁰. Section 101(2) makes it an offence for the owner or master of a ship to contravene any regulations made under the Act relating to precautions to be observed with respect to ships carrying petroleum within a port. Section 101(3) employs the principle of strict liability by making it an offence to discharge petroleum into Kenya's Exclusive Economic Zone and Outer Continental Shelf.

Offences under sections 100 and 101 each attract upon conviction, a fine of not more than two million Kenya Shillings or a maximum term of imprisonment of two years or both such fine and

⁴⁴ Section 98(2) of the Energy Act.

⁴⁵ *ibid*

⁴⁶ Section 99(2) of the Energy Act.

⁴⁷ Section 100(1)(a) of the Energy Act.

⁴⁸ Section 100(1)(b) of the Energy Act.

⁴⁹ Section 100(1)(c and e) of the Energy Act.

⁵⁰ Rule 32 of the Petroleum Rules

imprisonment. In addition, the ERC is empowered to suspend or revoke the licence issued⁵¹ and the person who has discharged petroleum into Kenya's territorial waters is responsible for cleaning the water and restoring it to its original status at his own cost⁵² for offences committed under section 100 and 101(3) respectively. An offence under section 102(w) which shall be expounded on in the next paragraph attracts a maximum fine of one million Kenya Shillings or the withdrawal of the operating licence or both.

2.2.1.3 Regulations for petroleum

The minister in charge of energy is empowered under section 102 to make certain regulations on the recommendation of the ERC. Relevant to this study is the minister's power under section 102(w) to make regulations determining the retail prices of petroleum products. As the author will demonstrate in his analysis of the Energy (Petroleum Pricing) Regulations, 2010, the minister erred in attempting to regulate the wholesale price of petroleum products but corrected his mistake in the Energy (Petroleum Pricing) (Amendment) Regulations, 2012⁵³.

2.2.2 The Petroleum Rules

As has already been noted, the Petroleum Rules were promulgated under the Petroleum Act and saved under section 123(2)(a) of the Energy Act when the Petroleum Act was repealed. The rules apply only to petroleum having a flashing point below 150Å° F⁵⁴ and do not apply to petroleum kept or transported by the armed forces⁵⁵ neither do they apply to transport of petroleum by a department of government⁵⁶. The Rules address transportation of petroleum by road⁵⁷, storage of petroleum⁵⁸, transport of petroleum by sea, import of petroleum as well as loading and unloading of petroleum⁵⁹.

Even a most casual glimpse at the Rules will reveal that little if any attempt was made to harmonize the rules in line with the Energy Act under which the Rules are deemed to have been made. For instance Rule 5(2) of the Rules provide that any person aggrieved by any order or decision of a licensing authority made under the provisions of the Rules may appeal to the Minister whose decision shall be final. This is despite the provision in section 89 (b) of the Energy Act to the effect that any person aggrieved by the action of a licensing agent may appeal to the ERC. Again the Rules provide that no person shall transport petroleum by road, except

⁵¹ Section 100(2) of the Energy Act.

⁵² Section 101(4) of the Energy Act.

⁵³ Legal Notice No. 26 of 2012 (Dated the 4th of April 2012)

⁵⁴ Rule 3(1) of the Petroleum Rules.

⁵⁵ Rule 4(2) of the Petroleum Rules.

⁵⁶ Rule 4(3) of the Petroleum Rules.

⁵⁷ Part II of the Rules Petroleum Rules.

⁵⁸ Part III of the Rules Petroleum Rules.

⁵⁹ Part IV of the Rules Petroleum Rules.

under the authority of a licence issued by the Licensing Authority⁶⁰. The Licensing Authority prescribed under the rules is every administrative officer in charge of a district⁶¹. The current practice is that ERC licences transporters of petroleum.

Save for Rule 31A (requirements for importation of petroleum) Rule 71 (marking of fuel meant for export with a chemical marker) and 73 (Liquefied Petroleum Gas Rules) which shall be discussed later in this Chapter, there is no need to engage into detailed analysis of the Rules taking into account the topic at hand other than to state the following:

1. With regard to transport of petroleum by road, the Rules prescribe *inter alia* for specifications for vehicles and receptacles for conveyance of petroleum and marking of the same with the words “Motor Spirit” or other similar words, that petroleum should not be transported with any other flammable substance, that a petroleum tanker should not remain stationary for more than 30 minutes within 100 yards of any building and powers of a licensing authority or police officer to inspect a vehicle transporting petroleum to ascertain compliance with the Rules.
2. With regard to storage of petroleum, the Rules provide for, among other things, licensing storage of petroleum, methods of storage of petroleum, requirements for applications for licences including the requirement to submit the plans and specifications of intended storage facilities, conditions applicable to all storage sheds, tanks and installations as well as precautions against fire.
3. With regard to transport by sea, import, loading and unloading of petroleum, the Rules provide for *inter alia*, issuance of notice by a ship owner or agent to the port manager prior to arrival at the port of a petroleum ship, the mode and procedures required to be followed in approaching the port, procedures to be followed in berthing, loading or discharging petroleum products, power of the port manager to order operations to cease, and precautions against fire on board a petroleum ship.

⁶⁰ Rule 7(1) of the Petroleum Rules.

⁶¹ Rule 5(1) of the Petroleum Rules.

2.2.3 The Petroleum (Amendment) Rules, 2012

The Petroleum (Amendment) Rules, 2012⁶² were signed by the Minister in charge of Energy on 4th April 2012 and were published on 10th April 2012. They introduce an amendment to Rule 31A of the Petroleum Rules discussed above by deleting the rule and replacing it with a new rule⁶³. The amendment is perhaps the latest and most clear indication of the much hyped plan to have KPRL cease to operate as a toll refinery and begin to operate as a merchant refinery. As a toll refinery, KPRL charges a processing fee to refine crude oil imported by an oil marketer and then hands over the refined products to the oil marketer. Under the merchant mode, KPRL will purchase its own crude oil, refine it and sell finished products to the oil marketers. The author will in the next chapter (Chapter 3) *inter alia* discuss why the model prescribed by the Petroleum (Amendment) Rules, 2012 is not, strictly speaking, a merchant mode of operation and why the model, while an improvement from the toll refinery mode of operation, is still unlikely to guarantee the consumer of petroleum products a fair price.

The Petroleum (Amendment) Rules, 2012 provide that KPRL shall process such minimum quantities of crude oil per calendar year as the Minister⁶⁴ may from time to time prescribe⁶⁵. It further provides that any person engaged in the importation of refined petroleum products other than bitumen for use in Kenya shall purchase from KPRL such quantities of refined petroleum products derived from the processing of the minimum quantity of petroleum crude oil aforementioned as the Minister may prescribe having regard to the market share per product, of such importer⁶⁶. The Rules further compel all importers of refined petroleum products other than liquefied petroleum gas, bitumen and fuel oil for use in Kenya to, with effect from 1st July 2012, import through an open tender system centrally co-ordinated by the Ministry of Energy through the Kipevu Oil Storage Facility, Shimanzi Oil Terminal, Miritini LPG Import Terminal and KPRL at Changamwe in Mombasa⁶⁷.

Prior to the amendment, Rule 31A of the Petroleum Rules provided that all importers of refined petroleum products other than the three grades referred to above shall process such minimum quantities of petroleum crude oil as the Minister may from time to time prescribe at KPRL and the said refined petroleum products shall be imported through the Kipevu Oil Storage Facility and the Shimanzi Oil Terminal. The Rules further provided that all crude oil for refining and use

⁶² Legal Notice No. 24 of 2012.

⁶³ This in effect repeals the Petroleum (Amendment) (No. 2) Rules, 2003 and the Petroleum (Amendment) (No. 1) Rules, 2006 which introduced amendments to rule 31A of the Petroleum Rules.

⁶⁴ "Minister" as per the Energy Act means the minister for the time being responsible for energy.

⁶⁵ Rule 31A(1) of the Petroleum Rules.

⁶⁶ Rule 31A(2) of the Petroleum Rules.

⁶⁷ Rule 31A(3) and (4) of the Petroleum Rules.

in Kenya as well as all refined petroleum products other than the three grades referred to above shall be imported through an open tender system centrally co-ordinated by the Ministry of Energy.

2.2.4 The Petroleum (Amendment) Rules, 2000

These Rules amend Rule 71 of the Petroleum Rules and provide for all petroleum fuels meant for export except jet kerosene to be marked with a chemical marker approved by the Minister⁶⁸. They further provide for all illuminating kerosene intended for sale in the country to be marked with a particular kind of chemical approved by the Minister⁶⁹.

The Rules are meant to curb tax evasion through the sale in Kenya of petroleum fuels meant for export or the adulteration of diesel with illuminating kerosene intended for sale in Kenya. Export petroleum fuels are tax exempt hence selling them locally would amount to tax evasion. Illuminating kerosene intended for sale in Kenya attracts less taxes than diesel⁷⁰ and is generally cheaper than diesel⁷¹ and this makes the cost of diesel cheaper for a seller who adulterates his diesel with illuminating kerosene. Diesel adulterated with illuminating kerosene is of a lower quality or standard but is still usable hence the temptation by unscrupulous businessmen to adulterate their diesel with illuminating kerosene.

2.2.5 Rule 73 of the Petroleum Rules and the Energy (Liquefied Petroleum Gas) Regulations, 2009

Rule 73 of the Petroleum Rules took effect on 1st October 2006⁷². It provides that the standard capacities of cylinders for filling with LPG shall be one, three, six and thirteen kilogrammes and such cylinders shall be fitted with unified valves⁷³. The Rule further provided that no LPG cylinders shall be manufactured in, or imported into, Kenya other than those of the prescribed capacities and fitted with unified valves⁷⁴. It is the author's considered view that this provision ought to have been drafted differently since the issue the Rule is seeking to address is the use in Kenya of cylinders not of the specified capacity and not fitted with unified valves. What it ends up doing is prohibiting the potential manufacture of LPG cylinders not of the specified capacities and not having unified valves but destined for export. Prior to the promulgation of the Rule, different Oil Marketing Companies (OMCs) had cylinders with varying capacities and

⁶⁸ Rule 71(1) of the Petroleum Rules.

⁶⁹ Rule 71(2) of the Petroleum Rules.

⁷⁰ Diesel attracts Kshs. 8.24 and Kshs. 9 of Excise Duty and Road Maintenance Levy respectively while illuminating kerosene does not attract any Excise Duty or Road Maintenance Levy. See the Petroleum Insight; 1st Quarter; January – March 2012 p. 36. The Petroleum Insight is published quarterly by the Petroleum Institute of East Africa.

⁷¹ For instance in the June 2012 prices released by the ERC, the price for dual purpose kerosene in Nairobi is Kshs. 83.2 while that of diesel is Kshs. 105.5

⁷² Rule 73(2) of the Petroleum Rules.

⁷³ Rule 73(2)(a) of the Petroleum Rules.

⁷⁴ Rule 73(2)(b) of the Petroleum Rules.

the valves fitted on these cylinders were not uniform across the industry. In addressing this status quo, the Rule provided as follows:

1. That all LPG cylinders existing immediately before the rule came into effect be fitted with unified valves within a period of thirty (30) months from 1st October 2006⁷⁵.
2. That any cylinder not of the prescribed capacities and fitted with unified valves shall not be allowed for filling with LPG after the expiry of four 4 years from 1st October 2006⁷⁶.

The Rule directly addresses consumer concerns when it prescribes that every retail outlet selling LPG must have a properly calibrated weighing instrument in accordance with the Weights and Measures Act for verification of the net contents of LPG cylinders⁷⁷. It further provides for the establishment of an LPG cylinder exchange pool of which every importer, exporter or wholesaler of LPG must be a member and makes it an offence for any member of the LPG cylinder exchange pool to refuse to accept or recognise for exchange a cylinder belonging to another member.

The Energy (Liquefied Petroleum Gas) Regulations, 2009 (the LPG 2009 Regulations) by and large contain, in addition to other rules, similar rules to those contained in Rule 73 of the Petroleum Rules. Looking at them one is persuaded to believe that they were intended to repeal Rule 73 of the Petroleum Rules. However, what they end up doing is repealing the entire gamut of the Petroleum Rules when they provide that the Petroleum Rules are repealed⁷⁸. The effect of this provision is that the petroleum subsector has since 2nd July 2009 when the LPG 2009 Regulations were signed into law continued and to date continues to operate under the illusion that the Petroleum Rules and all amendments thereto are binding law governing the subsector. This is a reality that is hard to imagine. Ironical perhaps is the fact that amendments have continued to be effected to the Petroleum Rules despite their perceived repeal with the latest amendment being the Petroleum (Amendment) Rules, 2012 apparently “signed into law” on 4th April 2012. At a stakeholders forum organised by the ERC at the Kenya School of Monetary Studies on 3rd May 2012 to review ten pieces of draft regulations relating to the petroleum subsector where the author was present, the Director General of the ERC was put to task to explain why the industry continued to operate under the assumption that the Petroleum Rules

⁷⁵ Rule 73(2)(c) of the Petroleum Rules.

⁷⁶ Rule 73(2)(d) of the Petroleum Rules.

⁷⁷ Rule 73(2)(e) of the Petroleum Rules.

⁷⁸ Rule 19 of the Energy (Liquefied Petroleum Gas) Regulations, 2009.

were in force yet the same had been repealed by the LPG 2009 Regulations⁷⁹. The ERC Director General admitted that the repeal of the Petroleum Rules by the LPG 2009 Regulations was an error and alluded to the existence of a legal notice published to revoke the repeal. When asked to produce a copy of that notice⁸⁰, he said that the same would be circulated to the OMCs. To date the author has not come across any such notice.

In addition to replicating some of the rules contained in Rule 73 of the Petroleum Rules the LPG 2009 Regulations lay the framework for the licensing of import, export, storage, wholesale, retail, transportation and filling of LPG⁸¹. The Regulations require that all accidents involving LPG or the transportation of LPG, accidental release of LPG or fires involving LPG be reported by licensees within 48 hours of their occurrence⁸². They further require that cylinders should not be filled, defaced, have their brand altered, damaged, repaired or submitted for maintenance without the authority of the brand owner⁸³.

Among other requirements, all importers of LPG are required to have an oil cleanup plan that conforms to the national oil policy⁸⁴ and be members of the Oil Spill Mutual Aid Group⁸⁵. Those seeking licences for LPG bulk storage on the other hand are required to meet certain conditions that are meant to ensure that the facility for which a licence is sought is safe for LPG bulk storage⁸⁶. The same applies to those seeking a licence to fill LPG into cylinders⁸⁷. To curb the menace of illegal refilling of cylinders, the LPG 2009 Regulations provide that wholesalers of LPG in cylinders shall not buy or sell LPG in cylinders from unlicensed persons⁸⁸ and retailers of LPG in cylinders shall not buy LPG in cylinders from unlicensed persons⁸⁹. Transporters of LPG are also required not to transport LPG from unlicensed persons or discharge LPG to unlicensed persons⁹⁰. The Regulations further prescribe requirements for those seeking licenses to transport LPG by road⁹¹. The requirements prescribed go beyond regulating the transporter

⁷⁹ The question was posed by a supply manager of one of the five leading OMCs by market share.

⁸⁰ This was posed by the said supply manager.

⁸¹ Rule 4 of the LPG 2009 Regulations.

⁸² Rule 6 of the LPG 2009 Regulations.

⁸³ Rule 7 of the LPG 2009 Regulations.

⁸⁴ Rule 8(7)(a) of the LPG 2009 Regulations.

⁸⁵ Rule 8(7)(b) of the LPG 2009 Regulations.

⁸⁶ Rule 9 of the LPG 2009 Regulations.

⁸⁷ Rule 10 of the LPG 2009 Regulations.

⁸⁸ Rule 11(5) of the LPG 2009 Regulations.

⁸⁹ Rule 12(4) of the LPG 2009 Regulations.

⁹⁰ Rule 13(6) of the LPG 2009 Regulations.

⁹¹ Rule 13 of the LPG 2009 Regulations.

and extend to his drivers by dictating certain minimum requirements for drivers transporting LPG⁹².

There is established an LPG Cylinder Exchange Pool under the regulations to which every person conducting filling and wholesale of LPG in cylinders must be a member⁹³. For a person to qualify to join the LPG Cylinder Exchange Pool, he/she/it must *inter alia* own at least 5000 cylinders of a particular brand and conforming to the prescribed standard⁹⁴.

Licenses under the Regulations are required to take all reasonable and proper steps to ensure that the conditions of the licence and the provisions of the regulations are known to all persons employed in the licensed premises and that unauthorised persons are not let into the premises⁹⁵. The penalty prescribed for contravening the Regulations is a maximum fine of one million shillings, imprisonment for a term not exceeding one year or both such fine and imprisonment⁹⁶. The ERC may in addition revoke or suspend the licence issued⁹⁷.

2.2.6 The Petroleum (Amendment) Rules, 2002

These rules introduce a new rule (Rule 72) to the Petroleum Rules that compels importers, exporters and wholesalers of petroleum products to submit certain information to the Minister of Energy. Such information includes⁹⁸:

1. the quantity of petroleum or petroleum products sold in each month including the type of petroleum and its consumer category;
2. the quantity of petroleum exported in each month including the type of petroleum and its destination;
3. the price of the petroleum in United States dollars and the date of arrival;
4. copies of bills of lading;
5. a list of all storage depots and service or filling stations in Kenya showing their capacity at the beginning of the months of January and June in every year; and
6. such information as the Minister may require.

⁹² Rule 13(8) of the LPG 2009 Regulations.

⁹³ Rule 14(5) of the LPG 2009 Regulations.

⁹⁴ Rule 14(8)(a) of the LPG 2009 Regulations.

⁹⁵ Rule 16 of the LPG 2009 Regulations.

⁹⁶ Rule 17(1) of the LPG 2009 Regulations.

⁹⁷ Rule 17(2) of the LPG 2009 Regulations.

⁹⁸ Rule 72(1) of the Petroleum (Amendment) Rules, 2002.

Importers of petroleum are in addition to the above, required to submit to the Minister information regarding⁹⁹;

1. the quantity of crude processed and the products yielded;
2. the owner of such crude and such yielded products;
3. the quantity of refined petroleum products imported for sale in the country; and
4. the quantity of foreign financed petroleum products;

Giving false information or failing, refusing or neglecting to give information amounts to an offence punishable under the Rules¹⁰⁰.

2.2.7 The Energy (Petroleum Strategic Stock) Regulations, 2008

The Regulations provide for the maintenance of a strategic stock of petroleum products to serve as a strategic reserve of petroleum products in the country, ensure continuity of supply of petroleum products in the event of disruption of supply as well as to stabilise domestic prices of petroleum products¹⁰¹. The strategic stock shall be equivalent to ninety days consumption of premium motor spirit, illuminating kerosene, jet fuel, automotive gasoil and liquefied petroleum gas¹⁰² and shall be replenished in the event of consumption or drawdown¹⁰³. The Petroleum Strategic Stock shall be procured by NOCK and stored by KPC¹⁰⁴.

2.2.8 The Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010

These Regulations, prior to the amendment mentioned hereinafter, provided for the importation of a certain portion of Kenya's petroleum products requirements by NOCK¹⁰⁵. The regulations gave NOCK a right to import 30% of Kenya's total requirements of crude oil, jet fuel and automotive gasoil¹⁰⁶. The Energy (Importation of Petroleum Products) (Quota Allocation) (Amendment) Regulations, 2012 that were signed into law on 4th April 2012 amended the Regulations to give KPRL 100% crude oil importation quota in line with the plan to make it a merchant refinery¹⁰⁷. The foregoing amendment thus makes KPRL the only importer of crude oil into Kenya. NOCK retains its import quota of 30% for jet fuel and automotive gasoil¹⁰⁸.

⁹⁹ Rule 72(4) of the Petroleum (Amendment) Rules, 2002.

¹⁰⁰ Rule 72(6) and (7) of the Petroleum (Amendment) Rules, 2002.

¹⁰¹ Rule 3 of the Energy (Petroleum Strategic Stock) Regulations, 2008.

¹⁰² Rule 4 of the Energy (Petroleum Strategic Stock) Regulations, 2008.

¹⁰³ Rule 5 of the Energy (Petroleum Strategic Stock) Regulations, 2008.

¹⁰⁴ *ibid*

¹⁰⁵ Rule 3(2) of the Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010.

¹⁰⁶ Rule 3(3) of the Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010.

¹⁰⁷ Rule 3(a) and 4 of the Energy (Importation of Petroleum Products) (Quota Allocation) (Amendment) Regulations, 2012.

¹⁰⁸ *ibid*

The Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010 as amended can be said to be inconsistent with the draft Energy (Importation of Petroleum) Regulations, 2012 insofar as the draft Regulations provide for the importation of crude oil through the Open Tender System¹⁰⁹. One can raise a valid argument that when crude oil is imported into Kenya by a successful bidder in the Open Tender System, regardless of the fact that the importer is obligated to sell the crude oil to KPRL, the actual importer, strictly speaking, is the successful OTS bidder and not KPRL. There is therefore a need to amend the Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010 to take into account the fact that crude oil will not be directly imported by KPRL but that KPRL will purchase 100% of the crude oil imported into Kenya by the successful bidder in the OTS. The draft Energy (Importation of Petroleum) Regulations, 2012 are discussed later in this chapter.

Save for the allocation of 100% of the crude oil importation quota to KPRL, it is not clear what objective is intended by allocating NOCK 30% of the import requirements for jet fuel and automotive gasoil. Since the formation of NOCK was precipitated by the oil crisis of the 1970's (1973/74 and 1979/80) and the correspondent supply disruptions and price hikes,¹¹⁰ one would imagine that the objective of the 30% quota allocation is perhaps to stabilise domestic prices. This objective is unlikely to be achieved in an environment where NOCK is competing in the market with other OMCs with the objective of making profit. What the Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010 end up doing is creating a situation where one OMC has an unfair advantage over the other OMCs in the market. The author will discuss this issue in greater detail in Chapter 3.

2.2.9 The Energy (Minimum Operational Stock) Regulations, 2008

These regulations provide for maintenance of physical operational stock of petroleum products by all importers of petroleum products intended for use in Kenya¹¹¹. The purpose of maintaining the stock is to ensure short term supply of petroleum products in the event of disruption of supply¹¹². In determining the minimum operational stock to be maintained, the yield expected from the crude oil to be processed at KPRL is taken into account provided that the said crude oil is physically present at KPRL or at any petroleum company or within a harbour in Kenya¹¹³.

¹⁰⁹ Rule 6(1) of the draft Energy (Importation of Petroleum) Regulations, 2012

¹¹⁰ See information about NOCK available at <http://www.nockkenya.co.ke/aboutus/index.php?flag=aboutus&abt=1> (accessed 2nd June 2012)

¹¹¹ Rule 3(1) of the Energy (Minimum Operational Stock) Regulations, 2008.

¹¹² Rule 3(2) of the Energy (Minimum Operational Stock) Regulations, 2008.

¹¹³ Rule 4(1)(a) of the Energy (Minimum Operational Stock) Regulations, 2008.

Also considered are refined petroleum products belonging to any company stored at KPRL, KPC, Kipevu Oil Storage Facility (KOSF) or any private depot¹¹⁴.

Each OMC's share in KPC line fill¹¹⁵, foreign financed stocks held by any OMC, petroleum products or crude oil in the high seas, off-specification products, petroleum products stock in any petroleum company's retail network (service and filling stations), stock in consumer depots or in transit from one depot to another does not constitute minimum operational stock¹¹⁶.

The minimum operational stock for each petroleum product is spelt out in the Schedule to the Regulations in terms of days' consumption to be determined in accordance with the consumption figures for the previous two quarters of the year¹¹⁷ for each importer of petroleum products.

2.2.10 The Energy (Petroleum Pricing) Regulations, 2010

These Regulations govern the pricing of petroleum products by determining the maximum wholesale price and the maximum retail pump price for super petrol, regular petrol, kerosene and automotive diesel through a formula contained in the Regulations¹¹⁸.

The power of the Minister of Energy to regulate the wholesale price of petroleum products is in doubt owing to the fact that under section 102 of the Energy Act (Regulations for petroleum), the Minister is empowered to make regulations for:

“determining the retail prices of petroleum and petroleum products (*emphasis mine*)”

It is perhaps on the realization that he does not have powers under the Energy Act to determine the wholesale prices of petroleum products that the Minister, in the Energy (Petroleum Pricing) (Amendment) Regulations, 2012¹¹⁹, prescribed a combined maximum allowed margin of Kenya Shillings Ten (10) for each of the foregoing petroleum products without prescribing what percentage of the Kenya Shillings Ten (Kshs. 10) would be the wholesale margin and what percentage would be the retail margin¹²⁰.

¹¹⁴ Rule 4(1)(b),(c) and (d) of the Energy (Minimum Operational Stock) Regulations, 2008.

¹¹⁵ This refers to petroleum products contained in the Kenya Pipeline Company's petroleum products pipeline where “petroleum products pipeline” does not include storage facilities.

¹¹⁶ Rule 5 of the Energy (Minimum Operational Stock) Regulations, 2008.

¹¹⁷ Rule 6 of the Energy (Minimum Operational Stock) Regulations, 2008.

¹¹⁸ Rule 3(1) of the Energy (Petroleum Pricing) Regulations, 2010.

¹¹⁹ Legal Notice No. 26 of 2012

¹²⁰ Rule 6 of the Energy (Petroleum Pricing) (Amendment) Regulations, 2012.

The wholesale price of petroleum products is determined by factoring in the weighted average cost of petroleum products *ex* KPRL and *ex* KOSF including allowed pipeline and depot losses, the transport cost to the nearest depot including allowed depot losses and the allowed wholesale margin¹²¹. The retail price of petroleum products is determined by factoring in the wholesale price above, the retail margin and the delivery rate from the nearest wholesale depot to a retail dispensing site¹²².

Being that the retail margin and the wholesale margin have now been merged pursuant to the Energy (Petroleum Pricing) (Amendment) Regulations, 2012, the maximum wholesale prices of petroleum products may vary from one OMC to the other but the maximum retail prices will remain fixed. This is because each OMC is permitted to exercise liberty in determining what its retail margin and wholesale margin will be provided that the cumulative margin does not exceed ten shillings.

The Regulations also give a formula for arriving at the weighted average cost of petroleum products *ex* KPRL and *ex* KOSF¹²³.

2.2.11 The Energy (Petroleum Regulation Levy) Order, 2008

The Order provides for the imposition of a levy to be known as the Petroleum Regulation Levy¹²⁴ on petroleum products consumed in Kenya¹²⁵. The Order provides for the levy to be collected by the Kenya Revenue Authority (KRA)¹²⁶ and remitted to the Director General of the ERC¹²⁷. The ERC is required to account for all Petroleum Regulation Levy monies received by it from the KRA¹²⁸. The Regulations prescribe a levy of Kenya Shillings Fifty (Kshs. 50) per every 1,000 litres of premium and regular motor spirit, kerosene and diesel oil measured at 20°C and Kenya Shillings Forty (Kshs. 40) per every 1,000 litres of automotive gasoil measured at 20 °C¹²⁹.

2.2.12 Competition Laws

The government's decision to regulate the prices of petroleum products was informed by the perceived "little" competition among the OMCs and therefore high petroleum product prices¹³⁰. At the time when the pricing regulations came into force, the primary law addressing issues of

¹²¹ Rule 4(a) of the Energy (Petroleum Pricing) Regulations, 2010.

¹²² Rule 4(b) of the Energy (Petroleum Pricing) Regulations, 2010.

¹²³ Rule 5 of the Energy (Petroleum Pricing) Regulations, 2010.

¹²⁴ Rule 3(1) of the Energy (Petroleum Regulation Levy) Order, 2008.

¹²⁵ Rule 3(1) of the Energy (Petroleum Regulation Levy) Order, 2008.

¹²⁶ Rule 4 of the Energy (Petroleum Regulation Levy) Order, 2008.

¹²⁷ Rule 5(1) of the Energy (Petroleum Regulation Levy) Order, 2008.

¹²⁸ Rule 6 of the Energy (Petroleum Regulation Levy) Order, 2008.

¹²⁹ Schedule to the Energy (Petroleum Regulation Levy) Order, 2008.

¹³⁰ Bob Peterson; In Fuel Price Cap, The Devil is in the Details, Daily Nation, December 16, 2008

competition in Kenya was the Restrictive Trade Practices, Monopolies and Price Control Act¹³¹. The Act vested the government with the mandate to encourage competition in the entire economy by prohibiting restrictive trade practices¹³². The Act had many enabling sections which could apply in the promotion of competition but had two major weaknesses¹³³.

The first weakness derived from the fact that a pricing offence was considered committed only if there existed, or had existed, an arrangement or agreement among sellers in the market to influence prices¹³⁴. It specified with respect to pricing, that a practice was considered restrictive if it entailed¹³⁵:

“an agreement or arrangement between manufacturers, wholesalers or retailers to sell goods at prices or on terms agreed upon between themselves;”

The Act didn't therefore adequately address covert behaviour and inherent market failures that were witnessed in the petroleum subsector¹³⁶. Although a cartel didn't seem to exist, an oligopolistic structure supported cartel like market behaviour in determining petroleum product prices. The mode adopted was price leadership which did not require any arrangement or agreement among the sellers or producers of a product for it to be successful in fixing market prices. Thus the provisions of the Act as they pertained to price control on one hand and the existing market structure on the other limited the government's power to intervene in the pricing of products¹³⁷. This is notwithstanding the fact that the nature of the market demanded that the government be given more powers for effective intervention in cases where the prices did not reflect free market conditions¹³⁸.

The second weakness, associated with the aspect of the Act which applied to pricing issues in general, derived from the nature of penalties and the processes for identification of an offence, as well as prosecution and conviction of an offender¹³⁹. The penalties were considered too light for the nature of the offence. The law provided for a maximum fine of only Kshs. 100,000/=

¹³¹ Chapter 504 of the Laws of Kenya repealed by the Competition Act, 2010 which came into force on 1st August 2011.

¹³² Stephen Karekezi, Bereket Kebede, Patrick Nyoike, Benjamin Okech, Timothy Ranja: *Petroleum Marketing in Africa; Issues in Pricing, Taxation and Investment*, Africa Energy Policy Research Network, 1999 p. 41

¹³³ *ibid*

¹³⁴ *ibid*

¹³⁵ See section 6(1) (b) and (d) of the Restrictive Trade Practices, Monopolies and Price Control Act.

¹³⁶ Stephen Karekezi, Bereket Kebede, Patrick Nyoike, Benjamin Okech, Timothy Ranja: *Petroleum Marketing in Africa; Issues in Pricing, Taxation and Investment*, Africa Energy Policy Research Network, 1999 p. 42

¹³⁷ *ibid*

¹³⁸ *ibid*

¹³⁹ *ibid*

and/or imprisonment for a term not exceeding two years¹⁴⁰. As regards the process of identification of a restrictive trade practice, investigation and resolution of the same, there had to be a complainant who considered himself aggrieved by, for instance, certain pricing practises¹⁴¹. The complainant would then submit to the Monopolies and Prices Commissioner the complaint for investigation¹⁴². The Commissioner investigated the complaint and asked the person alleged to have committed a restrictive trade practice to respond to the allegations and enter a consent agreement with the complainant¹⁴³. If the foregoing failed, the Commissioner would refer the matter to the Minister to make an order¹⁴⁴ and any person aggrieved by the order of the Minister would appeal to the Restrictive Trade Practises Tribunal¹⁴⁵ and subsequently to the High Court¹⁴⁶. In certain instances, a case would drag on for a long period, sometimes for longer than a year¹⁴⁷.

For these reasons the violation of the Act was a low risk undertaking particularly for well established firms which tended to be more risk oriented such as the OMCs that existed in the petroleum subsector in Kenya¹⁴⁸. Complainants were most likely to be consumers since unfair pricing practises were in the best interest of nearly all the OMCs¹⁴⁹. Due to the lack of organisation among petroleum products consumers, their spatial and socio-economic diversity, it was difficult if not impossible to develop a commonality of interests on which an effective and strong complaint against the relatively powerful OMCs could be based¹⁵⁰.

The Competition Act, 2010 which repealed the Restrictive Trade Practices, Monopolies and Price Control Act has the potential to address most if not all of the weaknesses highlighted above. With regard to addressing covert behaviour and inherent market failures in the petroleum subsector, the Competition Act contains a broader definition of a restrictive trade practice than what was contained in the Restrictive Trade Practices, Monopolies and Price Control Act by encapsulating decisions and concerted practices which directly or indirectly fix prices¹⁵¹. Oligopolistic tendencies are likely to be interpreted under the Act as being decisions and/or

¹⁴⁰ ¹⁴⁰ See section 21 of the Restrictive Trade Practices, Monopolies and Price Control Act.

¹⁴¹ Section 13 of the Restrictive Trade Practices, Monopolies and Price Control Act.

¹⁴² *ibid*

¹⁴³ Section 15 of the Restrictive Trade Practices, Monopolies and Price Control Act.

¹⁴⁴ Section 17 of the Restrictive Trade Practices, Monopolies and Price Control Act.

¹⁴⁵ Section 20(1) of the Restrictive Trade Practices, Monopolies and Price Control Act.

¹⁴⁶ Section 20(2) of the Restrictive Trade Practices, Monopolies and Price Control Act.

¹⁴⁷ Stephen Karekezi, Bereket Kebede, Patrick Nyoike, Benjamin Okech, Timothy Ranja: *Petroleum Marketing in Africa: Issues in Pricing, Taxation and Investment*, Africa Energy Policy Research Network, 1999 p. 42

¹⁴⁸ *ibid*

¹⁴⁹ *ibid*

¹⁵⁰ *ibid* p. 43

¹⁵¹ Section 21 of the Competition Act, 2010

concerted practises meant to fix prices and therefore subject to an investigation by the Competition Authority.

With regard to penalties for offences under the Act, an enhanced penalty of imprisonment for a term not exceeding five years or a fine not exceeding ten million Kenya shillings or both such fine and imprisonment is provided for¹⁵².

As relates to investigation of restrictive trade practises, the Act provides that the Competition Authority may on its own initiative or upon receipt of information or complaint from any person or government agency or ministry, carry out investigation into any conduct or proposed conduct which is alleged to constitute or may constitute a restrictive trade practice¹⁵³. This is an improvement from the Restrictive Trade Practices, Monopolies and Price Control Act which required a complaint from a complainant for an investigation to be conducted. Persons aggrieved by the decisions of the Competition Authority appeal to the Competition Tribunal and subsequently to the High Court if aggrieved by a decision of the Competition Tribunal¹⁵⁴. This is certainly a shorter 3 stage decision making process involving the Authority, Tribunal and High Court than the longer 4 stage decision making process involving the Commissioner, Minister, Tribunal and High Court that existed under the Restrictive Trade Practices, Monopolies and Price Control Act. It is without a doubt a better process since functions that previously vested in the Commissioner and Minister are vested in a 10 member authority¹⁵⁵ which is not only more likely to dispense with its work faster and more competently but is also likely to be more impartial than individuals that occupied the offices of Commissioner and Minister.

The question as to whether the government should continue regulating the prices of petroleum products despite the enactment of the Competition Act, 2010 is one that continues to beg for answers. It is the author's considered view that price controls are unnecessary with the passing of the Competition Act, 2010 that addresses the weaknesses of the Restrictive Trade Practises, Monopolies and Price Control Act.

2.2.13 The Petroleum Subsector Draft Regulations

As their name suggests, the draft regulations listed below have not been passed into law. All indications however are that they will be passed into law. Save for the Draft Energy (Importation

¹⁵² Section 70 of the Competition Act, 2010.

¹⁵³ Section 31(1) of the Competition Act, 2010.

¹⁵⁴ Section 40 of the Competition Act, 2010.

¹⁵⁵ Section 40 of the Competition Act, 2010.

of Petroleum) Regulations, 2012 which have some relevance to this section, no attempt will be made to analyze the other pieces of draft legislation.

The Energy Act provides that before making recommendation of any regulations to the Minister, the ERC shall publish the proposed regulations for purposes of inviting proposals from the public, in such manner as it may deem fit, at least forty days before the regulations are submitted to the Minister¹⁵⁶. The following draft regulations were published in the Kenya Gazette issue of 23rd December 2011.

- a) The Energy (Licensing of Petroleum Businesses) Regulations, 2011¹⁵⁷.
- b) The Energy (Licensing of Petroleum Retail Businesses) Regulations, 2011¹⁵⁸.
- c) The Energy (Licensing of Petroleum Refining Businesses) Regulations, 2011¹⁵⁹.
- d) The Energy (Licensing of Petroleum Logistics Facilities and Businesses) Regulations, 2011¹⁶⁰.

The following draft regulations were published in the Kenya Gazette issue of 30th December 2011.

- a) The Energy (Licensing of Petroleum Road Transport Businesses) Regulations, 2011¹⁶¹.
- b) The Energy (Operation of Common user Petroleum Logistics Facilities) Regulations, 2011¹⁶².
- c) The Energy (Operation of Marine Petroleum Jetties) Regulations, 2011¹⁶³.
- d) The Energy (Petroleum Information and Statistics) Regulations, 2011¹⁶⁴.

The following draft regulations were published in the Kenya Gazette issue of 18th May 2012.

- a) The Energy (Operation of Petroleum Refining Business) Regulations, 2012¹⁶⁵.
- b) The Energy (Importation of Petroleum) Regulations, 2012¹⁶⁶.

¹⁵⁶ Section 110(3) of the Energy Act.

¹⁵⁷ Gazette Notice No. 16446.

¹⁵⁸ Gazette Notice No. 16447.

¹⁵⁹ Gazette Notice No. 16448.

¹⁶⁰ Gazette Notice No. 16449.

¹⁶¹ Gazette Notice No. 16646.

¹⁶² Gazette Notice No. 16647.

¹⁶³ Gazette Notice No. 16648.

¹⁶⁴ Gazette Notice No. 16649.

¹⁶⁵ Gazette Notice No. 6899.

2.2.13.1 The draft Energy (Importation of Petroleum) Regulations, 2012

These Regulations replicate some of the provisions of the draft Energy (Licensing of Petroleum Businesses) Regulations, 2011²⁰⁶ and rule 31A of the Petroleum Rules²⁰⁷. However, their focus is on the open tender system which is the only legal system they prescribe through which crude oil, super petrol, dual purpose kerosene and automotive diesel oil can be imported into Kenya. Why the rules seek to isolate and focus on crude oil, super petrol, dual purpose kerosene and automotive diesel oil insofar as regulating their importation through the open tender system is a question on its knees for answers. The effect however is that some refined petroleum products such as regular petrol, if imported²⁰⁸, must be imported through the open tender system²⁰⁹ but will not be subject to the Energy (Importation of Petroleum) Regulations, 2012 if and when they are passed.

The Regulations prescribe two different formats for agreements for importation through the open tender system to be entered into amongst importers of refined petroleum products and crude oil respectively²¹⁰ and provide for such agreements to be submitted to the ERC for approval²¹¹. The Regulations purport to revoke the Petroleum (Amendment) (No. 2) Rules, 2003 and the Petroleum (Amendment) (No. 1) Rules, 2006 which have already been repealed by the Petroleum (Amendment) Rules, 2012 discussed in paragraph 2.1.3 above²¹².

2.3 Petroleum subsector players

2.3.1 Oil Marketing Companies (OMCs)

There are 49 oil marketing companies in Kenya licensed by the ERC to engage in the import, export and wholesale of petroleum products²¹³. Many more companies are licensed to undertake

¹⁶⁶ Gazette Notice No. 6899.

²⁰⁶ See for example rule 4 of the draft Energy (Importation of Petroleum) Regulations, 2012 which provides for licensing of all petroleum importers that is similar but narrower in scope than rule 7(1) which also provides for licensing of all petroleum importers.

²⁰⁷ Rule 5 of the draft Energy (Importation of Petroleum Products) Regulations, 2012 provides for the importation of crude oil and certain petroleum products through the open tender system while rule 31A(3) of the Petroleum Rules provides for the importation of all refined petroleum products except liquefied petroleum gas, fuel oil and bitumen only through the open tender system.

²⁰⁸ The current situation is that all regular petrol in use in Kenya is obtained from KPRL and none is imported. It is likely that when KPRL is upgraded, regular petrol will be phased out in Kenya.

²⁰⁹ Rule 31A (3) of the Petroleum Rules.

²¹⁰ Rule 9(1) of the draft Energy (Importation of Petroleum Products) Regulations, 2012.

²¹¹ Rule 9(2) of the draft Energy (Importation of Petroleum Products) Regulations, 2012. You will recall from earlier discourse that ERC does not have power to approve contracts between industry players.

²¹² While the repeal is not express in the Petroleum (Amendment) Rules, 2012, the deletion and replacement of rule 31A which the Petroleum (Amendment) (No. 2) Rules, 2003 and the Petroleum (Amendment) (No. 1) Rules, 2006 had amended effectively means that the Petroleum (Amendment) (No. 2) Rules, 2003 and the Petroleum (Amendment) (No. 1) Rules, 2006 are automatically repealed.

²¹³ See the Valid Petroleum Business licensees as at 06.06.2012 available at <http://www.erc.go.ke/erc/licensing/PETROLEUM%20LICENCE%20REGISTER.pdf> (Accessed 17th June 2012)

the wholesale of petroleum products and/or import petroleum products for export²¹⁴. The licensing criteria has been simplified to facilitate the entry of indigenous traders into the oil business²¹⁵.

The market is dominated by multinationals which, as at January to December 2011, had a consolidated market share of 63 percent of the market as follows²¹⁶:

1. Kenolkobil Limited	21.2%
2. Total Kenya Limited	19.5%
3. Kenya Shell Limited	14.4%
4. Libya Oil Kenya Limited	<u>7.9%</u>
TOTAL	<u>63%</u>

NOCK came fifth with a market share of 4.5% bringing the market dominance of the five major companies to almost 70% of the downstream market.

The provisions in the Competition Act, 2010 meant to address abuse of dominant position refer to dominant undertakings as those which control the distribution of not less than 50% of the goods of a certain description²¹⁷. An undertaking is defined in the Act as any business carried on for gain or reward by an individual, a body corporate, an unincorporated body of persons or a trust in the production, supply or distribution of goods or the provision of any service²¹⁸. It would appear from this definition that unless two or more of the companies above having a market share of over 50% are so affiliated as to be construed as carrying on a joint business, the provisions on abuse of dominant position would not apply to them.

2.3.1.1 Non government owned companies

47 out of the 49 companies licensed by the ERC to engage in the import, export and wholesale of petroleum products are non government owned companies. NOCK is the only fully government owned company licensed to import, export and engage in the wholesale of petroleum products. KPRL is the only partly government owned company licensed to import, export and engage in the wholesale of petroleum products. Since KPRL is not, strictly speaking, an OMC, it shall not be discussed under this heading but will be discussed later in this chapter.

²¹⁴ *ibid*

²¹⁵ Prof. Albert Mumma: The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 71.

²¹⁶ The Petroleum Insight; 1st Quarter; January – March 2012 p. 34.

²¹⁷ Sections 23 and 24 of the Competition Act, 2010.

²¹⁸ Section 2 of the Competition Act, 2010

2.3.1.4 Government owned companies

NOCK is a private company limited by shares incorporated on the 3rd day of April 1981 under the Companies Act (Cap 486) as company No. C. 22249²¹⁹. The company's main objects are²²⁰:

“(a) to procure and supply petroleum.

(b) to carry on in all their branches any of the undertakings and businesses of exploring for, exploiting, producing, transporting, refining, storing, marketing and distributing petroleum and other oils and any derivatives and products thereof and any other substances, products and goods that may be conveniently dealt in by the Company.”

The company has a nominal share capital of Kenya Shillings 10,000,000.00 divided into five hundred thousand shares of Kenya Shillings 20 each²²¹. All these shares have been issued to the Government of Kenya with the Permanent Secretary to the Treasury of Kenya holding 499,990 shares and the Permanent Secretary to the Ministry of Energy holding 10 shares²²².

Save that the formation of NOCK was precipitated by the oil crisis of the 1970's (1973/74 and 1979/80) and the correspondent supply disruptions and price hikes which resulted in the country's oil bill comprising of almost one third of the total value of imports and therefore making petroleum the largest single drain of Kenya's foreign exchange earnings²²³ there is no object in NOCK's Memorandum of Association that suggests that the company should be engaged in the stabilisation of petroleum prices. There is therefore legitimacy in the argument that had the state intended to stabilise prices of petroleum products through NOCK it ought to have established NOCK as a statutory corporation with a defined mandate and not as a private company limited by shares under the Companies Act. Inasmuch as the Energy (Strategic Stock) Regulations, 2008 give NOCK the mandate to procure strategic stocks which are *inter alia* meant to stabilise the prices of petroleum products²²⁴, it is implied from the regulations that the strategic stock will be owned by the government owing to the fact that it will be funded through monies to be appropriated by parliament²²⁵. NOCK's mandate to import strategic stocks cannot therefore be stretched by dint of the provisions of the Energy (Strategic Stock) Regulations, 2008 to include price stabilisation. The Energy (Importation of Petroleum Products) (Quota

²¹⁹ National Oil Corporation of Kenya Limited Certificate of Incorporation.

²²⁰ National Oil Corporation of Kenya Memorandum of Association.

²²¹ G. Elfaki Ali, I.A.R. Elgizouli, B.A. Okech, P.M. Nyoike and M.R. Bhagavan: Energy Utilities and Institutions in Africa: African Energy Policy Research Network, 1996 p. 79

²²² *ibid*

²²³ See a brief history of NOCK available at <http://www.nockkenya.co.ke/aboutus/index.php?flag=aboutus&abt=1> (Accessed 18th June 2012).

²²⁴ Rule 3(c) of the Energy (Strategic Stock) Regulations, 2008.

²²⁵ Rule 6 of the Energy (Strategic Stock) Regulations, 2008.

Allocation) Regulations, 2010 and the Energy (Importation of Petroleum Products) (Quota Allocation) (Amendment) Regulations, 2010 which give NOCK a 30% petroleum products import quota allocation for both kerosene and automotive gasoil are silent on the objects behind their enactment. While the regulations are suggested to have been made under section 102 of the Energy Act which empowers the Minister of Energy to make certain regulations to govern the petroleum subsector, the said section does not give the Minister any power to designate import quotas. The author shall further discuss this issue in Chapter 3.

2.3.2 The Kenya Pipeline Company Limited (KPC)

KPC is the only company in Kenya that transports petroleum products through pipeline from Mombasa to Nairobi through to the western Kenya region. It is a state owned company established on 6th September, 1973 under the Companies Act and started commercial operations in 1978²²⁶. The Company is 100% owned by the Government of Kenya²²⁷. The main objective of setting up the Company was to provide efficient, reliable, safe and cost effective means of transporting petroleum products from Mombasa to the hinterland²²⁸. In pursuit of this objective, the Company constructed pipeline network, storage and loading facilities for transportation, storage and distribution of petroleum products²²⁹.

KPC was conceived and established on the rationale of bypassing the conventional system in which petroleum tankers were hauled from Mombasa to the markets up-country²³⁰. Thus the underlying argument for the construction of the pipeline was the inability of Kenya Railways to provide adequate locomotive power for haulage of petroleum fuels to Nairobi and other up-country destinations served by the railways network²³¹. Transportation of petroleum products by road was not only dangerous owing to the flammable nature of the products but also led to damage of the roads by petroleum tankers not to mention the risk of environmental pollution from oil spillage²³².

²²⁶ See the KPC company profile available at http://www.kpc.co.ke/index.php?option=com_content&view=article&id=155:company-profile&catid=36&Itemid=417 (Accessed 18th June 2012)

²²⁷ *ibid*

²²⁸ *ibid*

²²⁹ *ibid*

²³⁰ G. Elfaki Ali, I.A.R. Elgizouli, B.A. Okech, P.M. Nyoike and M.R. Bhagavan: Energy Utilities and Institutions in Africa: African Energy Policy Research Network, 1996 p. 93

²³¹ *ibid*

²³² *ibid*

2.3.3 The Kenya Petroleum Refineries Limited (KPRL)

KPRL was originally set up by Shell and the British Petroleum Company (BP) to serve the East African region in the supply of a wide variety of oil products²³³. The Company was incorporated in 1960, under the name East African Oil Refineries Limited²³⁴. At its inception, KPRL was mandated to import and refine crude oil for the East African region, the neighbouring hinterland and off-shore markets.²³⁵ Among its export markets were Rwanda, Burundi, Eastern Zaire and Southern Sudan (Now the Republic of South Sudan) in the landlocked hinterland and the offshore countries of the Comoros, Madagascar and Mauritius²³⁶. In time, with the establishment of other refineries within the region, and the decision by some countries to import refined products directly from the Persian Gulf – the spatial dimension of the mandate shrunk considerably²³⁷. Tanzania for example set up its small refinery in the 1970s while Uganda stopped processing crude oil in 1982 and instead began to import petroleum products from the Gulf – a cheaper supply alternative²³⁸. The off-shore export markets went the way of Uganda while Rwanda and Burundi also sharply reduced their dependence on KPRL after 1982, importing more than half of their requirements from the Gulf through Kenya and Tanzania²³⁹. OMCs operating in Kenya would have followed the example set by Uganda, Rwanda and Burundi were it not for the introduction of Rule 31A in the Petroleum Rules that compelled all importers of refined petroleum products to refine at KPRL such minimum quantities of petroleum crude as the Minister of Energy may from time to time prescribe²⁴⁰. This issue will be discussed further in Chapter 3.

KPRL is a limited liability company incorporated under the Company's Act. The Government of Kenya owns 50% of the company's equity and the other 50% is held by Essar Energy Overseas Limited²⁴¹.

2.3.4 The Energy Regulatory Commission (ERC)

The ERC is established under the Energy Act as a body corporate with perpetual succession and a common seal capable of *inter-alia* suing and being sued in its own name²⁴². The management of

²³³ See a brief history of KPRL available at <http://www.kprl.co.ke/profile.php> (Accessed 18th June 2012)

²³⁴ *ibid*

²³⁵ G. Elfaki Ali, I.A.R. Elgizouli, B.A. Okech, P.M. Nyoike and M.R. Bhagavan: Energy Utilities and Institutions in Africa: African Energy Policy Research Network, 1996 p. 69

²³⁶ *ibid*

²³⁷ *ibid*

²³⁸ *ibid*

²³⁹ *ibid*

²⁴⁰ This Rule has been discussed above.

²⁴¹ *supra* note 235

the ERC is vested in the Commissioners who total 8 in number²⁴³. The funds of the ERC consist, among other sources, such levies as the Minister may impose on the sales of electricity, petroleum and other energy sources²⁴⁴.

As far as the petroleum subsector is concerned, the objects and functions of the ERC are mainly to regulate importation, exportation, transportation, refining, storage and sale of petroleum and petroleum products²⁴⁵. The ERC has power to issue, renew, modify, suspend or revoke licences and permits for all undertakings and activities in the energy sector as well as to make recommendations of regulations for the energy sector²⁴⁶. Decisions of the ERC must be in writing and the order so given and reasons thereof must be served upon all parties to the proceedings, and published in the Kenya Gazette²⁴⁷. A person aggrieved by a decision of the ERC may appeal to the Energy Tribunal within thirty days of the decision²⁴⁸.

2.3.5 The Energy Tribunal

The Energy Tribunal is established under section 108 of the Energy Act and is mandated to hear appeals arising from decisions of the ERC²⁴⁹. It consists of five persons - a chairperson and vice chairperson appointed by the President of Kenya, in consultation with the Judicial Service Commission from among persons qualified to be judges of the High Court and three other members appointed by the Minister for Energy in consultation with the Attorney General²⁵⁰.

The jurisdiction of the Tribunal does not include the trial of any criminal offence or the hearing of any dispute that a licensee and any other party may have agreed to settle in accordance with their agreement²⁵¹. Appeals from the Tribunal are heard and determined by the High Court²⁵² and further appeals to the Court of Appeal are permitted under the Energy Act²⁵³.

²⁴² Section 4 of the Energy Act.

²⁴³ See section 10 of the Energy Act. The Chairperson is appointed by the president while five commissioners and the Director General are appointed by the Minister for Energy. The Permanent Secretary of the Ministry of Energy is also a commissioner.

²⁴⁴ Section 19 (1)(a) of the Energy Act. Also see the Energy (Petroleum Regulation Levy) Regulations, 2008 and the Energy (Petroleum Regulation Levy) (Amendment) Regulations, 2008.

²⁴⁵ Section 5 (a)(ii) of the Energy Act.

²⁴⁶ Section 6(a) and (b) of the Energy Act.

²⁴⁷ Section 25(1) of the Energy Act.

²⁴⁸ Section 26 of the Energy Act. The Tribunal may entertain an appeal after the expiry of the thirty-day period if it is satisfied that there was sufficient cause for not filing it within that period.

²⁴⁹ Section 107 of the Energy Act.

²⁵⁰ Section 108(2) of the Energy Act.

²⁵¹ Section 10 of the Third Schedule to the Energy Act.

²⁵² Section 11(3) of the Third Schedule to the Energy Act.

²⁵³ Section 11(6) of the Third Schedule to the Energy Act.

2.4 Conclusion

Despite the enactment of the Energy Act (Act No. 12 of 2006) to consolidate the various pieces of legislation that governed the Energy Sector, no deliberate effort appears to have been made to properly streamline the subsidiary legislation governing the petroleum subsector. The neat way to do this would have been to repeal all regulations enacted under the Petroleum Act at the time of repealing the Act and enact new regulations under the Energy Act. As things stand today, the regulations governing the petroleum subsector are contained in scattered pieces of legislation each with a long series of amendments with the potential to cause confusion and, among other things, discourage foreign investment in the subsector.

CHAPTER 3

INEFFICIENCIES, CHALLENGES AND BOTTLENECKS IN THE PETROLEUM SUB-SECTOR

Are they to blame for the high petroleum product prices?

3.1 Introduction

This Chapter seeks to interrogate the inefficiencies, challenges and bottlenecks bedeviling the petroleum subsector and likely to impact negatively on the prices of petroleum products. In arriving at the maximum prices at which various petroleum products should retail at, the costs incurred in importation, refining, supply and distribution are taken into consideration². If these costs are high due to the inefficiencies, challenges and bottlenecks in the petroleum subsector, as is currently the case³, the prices of petroleum products will certainly be high.

Since December 2010 when the ERC started regulating the prices of petroleum products, the maximum price determined by the ERC has remained the only price⁴. Despite this, some multinational OMCs have recorded losses⁵ and those that recorded profits did not witness a sharp increase or decline in their profits⁶. Ironically, some OMCs recorded higher profits under the price controlled regime than under the unregulated regime before it⁷. Could it be that the prices posted by OMCs before the price control regime were indeed competitive prices of products? If there were “excess” profits being made by the OMCs why didn’t some OMCs see an opportunity to significantly lower prices and thereby increase their volume and profits further? Why would NOCK not have done this? The foregoing only serves to confirm the real

² See the formula contained in the Energy (Petroleum Pricing) Regulations, 2010

³ This Chapter will discuss those inefficiencies, challenges and bottlenecks.

⁴ See the ERC published petroleum prices dating back to December 2010 available at www.erc.go.ke/erc/news_and_publications/?ContentID=7 accessed on 29th July 2012. OMCs have since December 2010 priced their products at the maximum price published.

⁵ Total Kenya Limited for instance made a loss of Kshs. 71,436 in its 2011 financial year while in 2010 when there wasn’t a price control regime, it made a profit of Kshs. 916, 205.

⁶ Libya Oil Kenya Limited for instance made a pre-tax profit of 935 million in 2010 and a pre-tax profit of 1.2 billion in 2011.

⁷ See Libya Oil Kenya Limited Audited Accounts as at December 31, 2011 p. 6

It is good that the price controls may not have yielded any significant benefit to the consumers of petroleum products that prior existing competitive market forces could not have yielded.

OMCs have argued that price capping ignores a fundamental practice in pricing dynamics where regions with relatively lower economic activity and predominantly rural enjoy subsidized rates (lower prices) compared to urban regions⁸. The delivery transport costs set out in the pricing regulations when added up have ensured that rural regions experience real costs and increased pump prices hence taking away the advantage the less economically empowered folk enjoyed under the unregulated regime⁹.

3.2 Inefficiencies and challenges in the legal and regulatory regime

3.2.1 Change from toll to merchant refinery

Prior to the enactment of the Petroleum (Amendment) Rules, 2012 which deleted rule 31A of the Petroleum Rules and replaced it with a new rule, OMCs were required by law to process a quantity of crude oil proportionate to their market share at the KPRL¹⁰. OMCs would then pay KPRL a processing fee and receive back their crude in the form of refined petroleum products after the crude is processed in the refinery¹¹. The inefficiencies, challenges and bottlenecks attributable to the KPRL will be discussed later in this Chapter¹². Worth noting at this point is that owing to those inefficiencies, challenges and bottlenecks, OMCs would prefer to import all their refined products requirements were it not for the legal requirement that they process a certain base load at the refinery¹³. It is obvious that the legal requirement compelling OMCs to process a certain quantity of crude oil at KPRL was meant to protect an inefficient refinery that, if exposed to competition from more efficient refineries in the Gulf and other parts of the world, would collapse¹⁴.

⁸ Letter from a leading oil marketer dated 8th December 2010 to the Director General, the Energy Regulatory Commission with a copy to the Permanent Secretary, Ministry of Energy.

⁹ *ibid*

¹⁰ See paragraph 2.1.3 of Chapter 2.

¹¹ *ibid*

¹² See paragraph 3.3.1 of this Chapter.

¹³ This conclusion is based on the trend witnessed with the other East African countries which stopped processing crude at KPRL and settled for the cheaper option of importing refined petroleum products from the Gulf. Uganda for instance stopped processing crude at KPRL in 1982. See paragraph 2.2.3 of Chapter 2.

¹⁴ Caroline Katisya – Njoroge, Company Secretary - KPRL, Oil and Gas: The Challenge of Protectionism in Kenya; available at <http://www.liverpoollawsociety.org.uk/userfiles/file/Society%20News/Oil%20and%20Gas%20The%20Challenge%20of%20Protectionism%20in%20Kenya.pdf> accessed 30th June 2011. Also see the National Energy Policy: Sessional Paper No. 4 of 2004 on Energy available at <http://www.afrepren.org/cogen/downloads/SessionalPaperNo.4of2004onenergy%20Kenya.pdf> (Accessed 30th June 2011). 27

Until recently when KPRL took the decision to change its mode of operation from a toll refinery to a merchant one¹⁵ attempts by the government to win the support of the private shareholders to modernise the facility met hostility from private shareholders who continued to veto resolutions on modernisation¹⁶. Indeed past attempts by two general managers and a company secretary/finance manager to modernise the facility ended up with one of the general managers being removed, the other being accused of running down the facility and the company secretary/finance manager being retired after being transferred to a local company.¹⁷ The opposition by private shareholders to modernisation follows the logic that if you have a law protecting you from competition and guaranteeing you of customers despite your inefficiency and substandard products, why would you want to sacrifice your dividends and even incur debt to modernise the facility. As the analysis on the inefficiencies, challenges and bottlenecks attributable to the KPRL will demonstrate, the ultimate price for those inefficiencies challenges and bottlenecks is paid by the consumers of the petroleum products¹⁸. Moreover, the fact that it is cheaper to import refined products than to process crude oil at the refinery means that consumers are paying a premium to maintain KPRL in operation¹⁹. Additionally, later in this chapter when Yield Shifts will be discussed, it will emerge that there is a real chance that consumers will continue to pay for the inefficiencies of KPRL well into the merchant regime if a resolution that does not involve passing the loss occasioned by the Yield Shift to the consumer is not arrived at²⁰.

In view of the foregoing one would expect that the law enacted to anchor the transition of KPRL from toll to merchant would not afford any form of protection to KPRL. Contrary to this expectation, the Petroleum (Amendment) Rules, 2012 compel all OMCs importing petroleum products other than bitumen for use in Kenya to purchase refined petroleum products from KPRL²¹. One would further expect that if some protection must be extended to KPRL, which is abhorred, that protection would be limited in time and scope. The protection extended to KPRL is not limited in time in that the Rules do not provide a time limit for instance five years within which OMCs will be compelled to buy refined petroleum products from KPRL. That protection is also not limited in scope in that the Rules compel OMCs to buy all the refined petroleum products yielded from the refinery as the Minister may prescribe having regard to the market

¹⁵ See "Migration to Merchant Mode" available at <http://www.kprl.co.ke/news.php> accessed 30th July 2012.

¹⁶ G. Elfaki Ali, I.A.R. Elgizouli, B.A. Okech, P.M. Nyoike and M.R. Bhagavan: *Energy Utilities and Institutions in Africa: African Energy Policy Research Network*, 1996 p. 72.

¹⁷ *Supra* note 11 at p. 72.

¹⁸ See paragraph 3.3.1 of this Chapter.

¹⁹ See paragraph 2.2.3 of Chapter 2.

²⁰ See paragraph 3.3.1.3 of this Chapter.

²¹ See paragraph 2.1.3 of Chapter 2.

share per product meaning that KPRL will sell all the refined petroleum products it produces from the crude oil to a predetermined and guaranteed market. This lessens the incentive for KPRL to fast track the modernisation process. KPRL and OMCs are working on an interim off-take agreement which provides that the refined petroleum products to be purchased by OMCs from KPRL are liquefied petroleum gas, premium motor gasoline, dual purpose kerosene, automotive gasoil, industrial diesel oil and fuel oil²². If this interim off-take agreement is signed in its present form then KPRL will not have a guaranteed market for products like Tops²³. This may serve as an incentive for KPRL to fast track the modernisation process and install plants that can break down Tops into products that can be used in the Kenyan market. The author will discuss the off-take agreement in greater detail later in this chapter when he discusses the Yield Shift²⁴.

3.2.2 Allocation of a 30% importation quota to NOCK

The Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010 and the Energy (Importation of Petroleum Products) (Quota Allocation) (Amendment) Regulations, 2012 give NOCK a 30% import quota for jet fuel and automotive gasoil. Section 103 of the Energy Act which empowers the Minister of Energy to make regulations for petroleum does not empower the Minister to make regulations on import quota allocations for petroleum products. Moreover, it is unclear what objective is intended by allocating NOCK 30% of the import requirements for jet fuel and automotive gasoil²⁵.

As has already been observed in chapter 2²⁶, NOCK has a market share of 4.5% of the Kenyan market and on this basis is the fifth largest OMC in Kenya. The first four largest OMCs hold a consolidated market share of 63%²⁷.

The Open Tender System dictates that OMCs importing refined petroleum products into Kenya must purchase refined petroleum products from KPRL in proportion to their market share²⁸. This requirement is informed by the limited ullage²⁹ at the common user petroleum logistics

²² Clause 1.1.49 and schedule 1 of the Interim Agreement for the Purchase of Refined Petroleum Products Produced by Kenya Petroleum Refineries Limited (30th July 2012 draft).

²³ Naphtha - a hydrocarbons mixture C5 – C6 paraffins and benzene which the refinery is not able to break down further. See www.kprl.co.ke/assets/msds/MSDS%20KPRL%20Tops.pdf accessed 31st July 2012.

²⁴ See paragraph 3.3.1.3 of this Chapter.

²⁵ See paragraph 2.1.8 of Chapter 2.

²⁶ See paragraph 2.2.1 of Chapter 2.

²⁷ *ibid*

²⁸ See paragraph 2.1.3 of Chapter 2.

²⁹ An industry term used to refer to space available for storage of petroleum and petroleum products.

facilities³⁰ such as the Kipevu Oil Storage Facility (KOSF). KOSF is a facility extending from the Kipevu Oil Jetty and includes storage tanks and interconnecting pipelines used for receiving, storing and transshipping petroleum products³¹. Ullage at KOSF is allocated to OMCs in proportion to their market share. The 30% import quota therefore effectively reverses the market share of other OMCs acquired through struggle over time in the market place in favour of NOCK. By allocating NOCK the ullage, the government essentially compels the rest of the OMCs to purchase products from NOCK to meet their market needs. Again, due to NOCK's actual limited market share of only 4.5%, NOCK is more often than not likely to find itself with excess petroleum products which it is unable to dispose in time to create ullage at KOSF for receipt of another cargo of refined petroleum products³². This has the potential of creating an artificial shortage of petroleum products.

3.3 Inefficiencies, challenges and bottlenecks attributable to the players and/or stakeholders

3.3.1 The Kenya Petroleum Refineries Limited

3.3.1.1 Use of outdated technology

KPRL supplies approximately 40% of petroleum products to the industry³³. It faces many operational challenges due to the out-dated technology in use³⁴. The processing efficiency of an oil refinery can be enhanced if the product mix ratios are changed to produce a larger proportion of the higher value products (LPG, petrol, kerosene and diesel) and both cheaper and more crude oil intake can be realized. This can be achieved through a Thermal Gasoil Unit (TGU) that converts fuel oil into lighter products. KPRL does not have such a unit but intends to install one in the planned upgrade of the refinery³⁵. Paragraph 3.2.1 above has highlighted the opposition to the upgrade of the refinery by the private equity holders at KPRL that has until recently been the key obstacle to the refinery upgrade. The planned upgrade of the refinery is expected to be completed in 2015³⁶. Until that time, consumers of petroleum products will continue to

³⁰ Common user petroleum logistics facilities are defined in the draft Energy (Operation of Common User Petroleum Logistics Facilities) Regulations, 2012 as petroleum logistics facilities owned or operated by a licensee for use exclusively by third party petroleum business licensees.

³¹ This is as per the definition contained in the Transportation and Storage Agreement between each OMC and KPC.

³² NOCK has only 79 service stations spread across the country while OMCs like Total Kenya Limited has more than 170 stations all around the country. See www.nockkenya.co.ke/downstream/index.php?flag=downstream&dst=1 and http://www.total.co.ke/os/OsKenya.nsf/V5_OPM/41BB80D591322C79C12570B40035BA06?OpenDocument accessed 31st July 2012

³³ Letter from a leading oil marketer dated 2nd December 2010 to the Permanent Secretary, Ministry of Energy and the Director General, the Energy Regulatory Commission.

³⁴ *ibid*

³⁵ See KPRL future investments available at <http://www.kprl.co.ke/profile.php?q=future> accessed 1st August 2012. Also see <http://www.kprl.co.ke/news.php> accessed 1st August 2012.

³⁶ John Njiraini and Macharia Kamau; Oil Refinery Seeks State Protection; The Financial Journal Pullout in the Standard, Tuesday, January 17, 2012.

shoulder the burden of high petroleum product prices owing to the following reasons among others:

1. Frequent electrical power interruptions³⁷ necessitate a shut-down of the refinery³⁷. KPRL takes about one week to restart its production units on the occurrence of each power outage³⁸. This causes product shortages, recycling of feed, wastage of fuel and generally enhanced operating costs³⁹. In addition, the frequent start ups increase safety risks at the refinery⁴⁰ hence higher expenditure on safety, health and environment programmes.
2. Higher than normal fuel oil production at the expense of high value products such as dual purpose kerosene and premium motor spirit due to the power interruptions⁴¹.
3. The push for a cleaner environment has seen the diesel sulphur specification become more stringent worldwide. Kenya's diesel sulphur specification is 500 Parts Per Million (PPM) maximum. The KPRL refinery has limited capability of removing sulphur from diesel and produces diesel with a sulphur content of 5,000 PPM or above while all imports through the OTS are under 500 PPM. The diesel from the refinery is commingled with diesel imported through the OTS. The high sulphur diesel has a negative impact on the environment and citizens of Kenya⁴². The irony is that Kenyans are paying more money for high sulphur diesel that is harmful to health and the environment while its neighbours that do not own any refinery are enjoying cleaner diesel imported at cheaper prices.
4. Because of its old technology KPRL's ability to add value on crude is very limited⁴³. KPRL generates unacceptably high quantities of residual oils when heavy crudes are processed without being blended with the light, sweet and expensive crudes such as Arab Berri, Zakum and Murban. For example, Arab Medium and Iranian Medium crudes, when processed unblended at KPRL, both generate more than 50% of residual oil, with a market value always below that of crude oil⁴⁴. Because of this technological constraint, these crudes, despite being cheaper than the light, sweet crudes, are only processed in very small quantities to generate residue needed for the manufacture of bitumen⁴⁵. For the same reason, Murban accounts for between 80 and 93 per cent by weight of the

³⁷ Prof. Albert Mumma: *The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework*; 2011 p. 66

³⁸ See news on the KPRL Power-plant Project available at <http://www.kprl.co.ke/news.php?news=80> accessed 2nd, August 2012.

³⁹ *ibid.* Also see Prof. Albert Mumma: *The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework*; 2011 p. 68

⁴⁰ *ibid*

⁴¹ Prof. Albert Mumma: *The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework*; 2011 p. 67

⁴² *ibid*

⁴³ Commission Paper on Petroleum Pricing Regulations Stakeholders Forum available at www.erc.go.ke/pricereg.doc accessed on 15th July 2011. p. 6.

⁴⁴ Stephen Karekezi, Bereket Kebede, Patrick Nyoike, Benjamin Okech, Timothy Ranja: *Petroleum Marketing in Africa; Issues in Pricing, Taxation and Investment*, Africa Energy Policy Research Network, 1999 p. 31

⁴⁵ *ibid*

annual crude oil intake at KPRL, as it produces close to 65 per cent of light and distillate products, and only about 35 per cent of residual oil⁴⁶ whose value as already noted above is almost half that of crude. This loss of value is recovered in the prices of the higher value products⁴⁷. In addition to the foregoing situation, the refinery at times posts fuel oil losses way above the 5% limit stipulated in the refinery data book. In some months, the refinery is known to post fuel oil losses of up to 9.5% (equivalent to Kshs. 3/litre)⁴⁸. If KPRL had the technology to finely distil the crude to the point of having very minimal quantities of low end products such as fuel oil, there would be no losses to recover in the prices of high value products and this would, to some extent, guarantee lower prices of petroleum products.

3.3.1.2 Deemed vs Actual stocks

Deemed stock as the name suggests refers to the stocks of each petroleum product that KPRL expects to get from refining a certain quantity of crude oil. Actual stock on the other hand refers to the stocks of each petroleum product actually obtained from refining a certain quantity of crude oil. As a result of its out-dated technology leading to inefficiency, the refinery is generally unable to meet programmed production resulting in significant deemed stock (paper stock). This idle stock owed by KPRL to OMCs but physically not available or accessible leads to escalated working capital costs since OMCs have to continue financing the import of fresh cargoes of crude despite the fact that they have not received refined petroleum products from previous cargoes⁴⁹. These high working capital costs are reflected in the prices of petroleum products⁵⁰. As it shall emerge in the discussion on Yield Shifts in the next paragraph, OMCs never get to realize the true worth of the crude they import.

3.3.1.3 Yield Shifts

Yield shifts refer to the act of restating paper stocks to the actual product produced over a defined period. Yield shifts at KPRL are usually from higher value to lower value stocks, for example from premium motor spirit, dual purpose kerosene or automotive diesel oil to fuel oil. For instance, for the period March 2002 to September 2010, KPRL tabulated the yield shift as follows⁵¹:

⁴⁶ *ibid*

⁴⁷ *ibid*

⁴⁸ Letter from a leading oil marketer dated 2nd December 2010 to the Permanent Secretary, Ministry of Energy and the Director General, the Energy Regulatory Commission.

⁴⁹ *Ibid*

⁵⁰ The price regulations only cap the maximum prices of four products (see paragraph 2.1.10 of Chapter 2). Nothing in the regulations bars OMCs from recovering such costs in the prices of unregulated products.

⁵¹ E-mail dated 9th June 2012 from the Manager, Hydrocarbon Economics, KPRL to the Supply Managers of the OMCs subsequently forwarded to the author on 14th June 2012.

PRODUCT	GAIN (MT)	LOSS (MT)
Liquefied Petroleum Gas		6,148
Premium Motor Spirit		61,762
Regular Motor Spirit		6,884
Dual Purpose Kerosene		40,114
TOPS (Naphtha)		6,780
Automotive Gasoil		17,719
Fuel Oil	121,928	
Fuel and Loss	17,479	
SUM TOTAL	139,407	139,407

The figures above suggest that a loss in one product is compensated by a gain in another regardless of the value of each of those products. If effected, this yield shift will see OMCs incurring a consolidated loss running into billions of shillings. On the basis of these figures, and relying on the provisions of clause 9.03 of the Mombasa Refinery Processing Agreement between KPRL and each OMC as well as Side Agreement No. 15 between KPRL and each OMC, KPRL avers that it has fully met its obligations under the said Processing Agreement and Side Agreement. Clause 9.03 of the Processing Agreement provides as follows:

9.03 if during any Refinery Operating Period the Refinery Company is unable to adhere to its operating programme despite having used all reasonable endeavours to do so with the result that it cannot deliver to all Refinery Users the exact entitlement of products which should result from the programmed processing of their feedstock then the User's products entitlement as established under clause 9.02 shall be adjusted in accordance with the provisions of Clause 9.04.

The said clause 9.04 provides as follows:

9.04 The Refinery Company shall determine in respect of each Refinery Operating Period the actual total yield of each product obtained from the total Refinery operating programme and shall determine the difference between such actual total yield of each product and the aggregate of the estimated yields of such product as notified by the Refinery

Company to each Refinery User. Any differences so determined for each product shall be allocated in accordance with the following provisions:-

- a) in respect of each product any loss so determined shall be allocated to Refinery Users in the ratios of their separate estimated yields of such product as notified to them by the Refinery Company for that Refinery Operating Period.
- b) in respect of each product any gain so determined shall be allocated to Refinery Users in the ratio of their separate estimated yields of such product as notified to them by the Refinery Company for that Refinery Operating Period;
- c) in the event that such determination shows a simultaneous loss of one or more products and a corresponding consequential gain in one or more products, then the loss shall be allocated to Refinery Users in the ratio of their separate estimated yields of such product or products as notified to them by the Refinery Company for that Refinery Operating Period and the gain shall be allocated in the same ratio as the loss *(emphasis mine)*.

Side Agreement No. 15 does not address the issue of yield shifts per se but requires that before an OMC is permitted to take delivery of any refined petroleum product his stock entitlement of refined petroleum products (which includes paper stocks) and total hydrocarbon value being refined petroleum products plus feedstocks⁵² must be in a positive position. An OMC in a negative stock entitlement and hydrocarbon position may however be allowed to take delivery of refined petroleum products if it provides a financial guarantee and receives a unanimous waiver from all other Refinery Users. Maintaining a positive stock entitlement and hydrocarbon position has never been a challenge to OMCs owing to the paper stocks.

OMCs have contested the above figures and refused to co-operate in the change from toll to merchant unless the losses they have incurred in the high value stocks being purportedly compensated by gains in lower value stocks are addressed. This has prompted the Ministry of Energy to give directions on the matter. A letter dated 9th July 2012 addressed to chief executive officers of OMCs signed by the Permanent Secretary of the Ministry of Energy (Ref. No. ME/CONF/7/1/2) whose subject is “Interim Arrangement for KPRL Operations under the Merchant Processing Mode” states in relevant part as follows:

“...I am aware that KPRL and the OMCs wish to have a proper and duly signed respective agreements in place that will provide clear guidelines on the operations under the merchant

⁵² Feedstocks is a term used to refer to crude oil.

processing mode. However, the OMCs have also raised concern, based on individual legal advices, that signing a new agreement with KPRL without addressing historical issues under the current Processing Agreement will put their existing claims at risk.

Although the yield shift process is provided for in the Processing Agreement, the main item in contention is the proposed yield shift which KPRL intends to effect in the product entitlements covering the period **March 2002 – September 2010 and from October 2010 to the last date of Processing Crude under the Tolling arrangement.** The OMCs estimate that this will result in a substantial loss. Given that this loss is of great concern to OMCs, concerted efforts will be required amongst all stakeholders to get a resolution.

In view of the progress made so far to have KPRL become a merchant refinery given that this is a better mode for the Country and while fully appreciating the concerns raised, I hereby request for more time to resolve this outstanding yield shift matter. The commitment by the Ministry of Energy is that a resolution will be found **within 3 months** from July 2012. During this period, the Yield Shift numbers will be validated through a forensic audit conducted by a professional body acceptable to both KPRL and OMCs, consultations held with the relevant stakeholders and a final solution agreed upon. The Audit's Terms of Reference shall be jointly drawn by KPRL and OMCs within two days from the date of this letter. The forensic auditor's fees will be jointly settled by KPRL and OMCs in the ratio of 25% for KPRL and 75% for OMCs.

It is therefore acknowledged that:

- The Yield Shift matter exists and requires urgent resolution;
- The Yield Shift numbers must be consistent with the current processing agreement; and,
- There is commitment to resolve this impasse by October 2012.

With this commitment, I urge the OMCs to engage KPRL and ERC to finalize and sign an interim Product Off-take Agreement. I also hereby urge KPRL to avoid effecting the yield shift unilaterally to the OMCs entitlements during that same period in a manner that would not have been agreed with the OMCs..."

The Product Interim Off-take Agreement to be entered into between KPRL and oil marketers and to be valid for three months (currently in draft form⁵³) takes into account the contents of the foregoing letter by providing as follows in its preamble:

“The Parties recognise that this Agreement has been entered into pursuant to the conversion of KPRL’s business model from toll to merchant refining. This Agreement is a transitional document that will last for a period of three months. The Parties recognise that the agreements between the parties concerning the processing of crude entered into prior to this Agreement (i.e. the Processing Agreements and all other connected agreements) shall continue in force and all rights under those agreements shall not be affected. In addition, the Parties are cognisant of the efforts of the Ministry of Energy to ensure that the determination of any toll stocks will be completed during the tenure of this Agreement.”

The fact that some OMCs had proposed that the loss occasioned to OMCs by the yield shift be captured in the price formula contained in the Energy (Petroleum Pricing) Regulations, 2010 for absorption by consumers⁵⁴ means that there is a real chance that this may be one of the solutions to the yield shifts dispute between KPRL and OMCs. If this is adopted as the solution to the yield shift dispute, it effectively means that Kenyans will for a long time continue to pay the price for having an outdated and inefficient refinery long after the refinery has changed from a toll to a merchant mode of operation. The possibility that the yield shift loss will continue to be recovered well after the KPRL refinery has been modernised cannot be dismissed as being remote.

3.3.2 The Kenya Pipeline Company Limited

The primary mode of transporting petroleum products in Kenya is through pipeline⁵⁵. KPC owns the pipeline infrastructure that consists of the petroleum products pipeline, storage facilities and pump stations. The petroleum products pipeline is 896 kilometres long running across the country from the coastal town of Mombasa, through Nairobi to Eldoret and Kisumu which serves the local and neighbouring countries’ markets⁵⁶. Products transported by the petroleum products pipeline are super petrol, regular petrol, automotive gas oil, illuminating kerosene and aviation kerosene⁵⁷.

⁵³ As at 30th July 2012

⁵⁴ Letter from a leading oil marketer dated 2nd December 2010 to the Permanent Secretary, Ministry of Energy and the Director General, the Energy Regulatory Commission.

⁵⁵ Prof. Albert Mumma: The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 68

⁵⁶ *ibid*

⁵⁷ *ibid*

The pipeline infrastructure consists of KOSF which acts as an import handling facility for petroleum products⁵⁸. The pipeline also draws some of the petroleum products from the KPRL after the crude oil has been processed⁵⁹. A parallel pipeline has been constructed from Nairobi to Eldoret to boost the supply of petroleum products to Western Kenya. This is meant to reduce transportation of petroleum products by road⁶⁰.

Plans to extend the pipeline from Eldoret to Kampala, Uganda under the Kenya Uganda Pipeline Project, a governments - private sector partnership, faced a major setback in 2012 when the Government of Kenya and that of Uganda, in a letter dated June 20, 2012 addressed to the Managing Director, Tamoil East Africa Limited (the Project Developer), terminated the Heads of Agreement between the two governments and the Project Developer.

3.3.2.1 Challenges in Storage and Pipeline Transportation

KPC has been pumping at the reduced throughput of 450 M³/hr against an installed capacity of 880 M³/hr due to the following factors⁶¹:

- a) Low evacuation of petroleum products ex KPC Nairobi Terminal to OMC Nairobi terminals due to disproportionate ownership of stocks in the KPC system. The product transfers from the KPC Nairobi Terminal to the OMC Nairobi terminals is currently at an average of 5000M³ per day based on requests by the OMCs against a handling capacity of 10,000M³ per day.
- b) Utilisation of the KPC system as storage/trading tool instead of a supply system means that OMCs have products in the system that are not being evacuated in a timely manner, either for the local market or for transit, resulting in clogging of the system.
- c) Frequent rehabilitation of aged tanks results to ullage constraints and lack of operational flexibility.

The foregoing notwithstanding, the total storage capacity within the KPC pipeline system is only 612,233M³ distributed among the depots located at Kipevu, Moi International Airport, Jomo Kenyatta International Airport, Nairobi Terminal, Nakuru, Eldoret and Kisumu as follows⁶²:

⁵⁸ *ibid*

⁵⁹ *ibid*

⁶⁰ *ibid* at p. 69

⁶¹ Prof. Albert Mumma: The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 69

⁶² See KPC Pump Stations and Depots available at

http://www.kpc.co.ke/index.php?option=com_content&view=article&id=185&Itemid=353 accessed 6th August 2012.

Depot	Total Capacity M ³
Nairobi Terminal	10,580
Jomo Kenyatta International Airport	54,141
Moi Airport Mombasa	7,349
Kipevu Oil Storage Facility	326,233
Nakuru Depot	30,553
Eldoret Depot	48,089
Kisumu Depot	45,288
Grand Total	612,233

As can be discerned from the above table KOSF, the primary facility of receiving imported refined petroleum products to Kenya, has a storage capacity of 326 million litres. It has an operational capacity of 269 million litres⁶³. This capacity is not adequate for regional demand of petroleum products estimated at 420 million litres per month⁶⁴.

With such constrained capacity coupled with a low evacuation of petroleum products from the KPC system, Kenya is unable to take advantage of a drop in international prices of petroleum products by procuring more petroleum products when the international prices are low and less when the international prices are high. The prices of petroleum products in Kenya can thus fluctuate by as much as Kenya Shillings 7 per litre owing to a fluctuation of the international prices of petroleum products⁶⁵. Ironically, the KPC system was used in 2008 by an OMC to take advantage of fluctuations in the international price of oil but for the wrong reason of defrauding Kenyans in speculative purposes that led to one of the biggest scandals in Kenya's history⁶⁶. Complaints from other OMCs strongly suggest that Triton Petroleum Limited had an undue advantage over other players in the use of KPC facilities as it reportedly often held stocks that took half the space at KOSF for speculative activities⁶⁷. In early and mid-2008, the price of oil

⁶³ Prof. Albert Mumma: The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 69

⁶⁴ *ibid*

⁶⁵ For instance, the price of super petrol in Nairobi in March 2012 was Kshs. 111 per litre. In April it went up seven shillings to Kshs. 118 per litre. See Petroleum Prices available at http://www.erc.go.ke/erc/news_and_publications/?ContentID=7 accessed 6th August 2012.

⁶⁶ The scandal involving Triton Petroleum Limited where Kenya is said to have lost at least Kshs. 7.6 billion. See Analysis of the Triton Oil Scandal; African Centre for Open Governance; p. 1 available at <http://www.africog.org/reports/Analysis%20of%20the%20Triton%20Oil%20Scandal.pdf> accessed 7th August 2012.

⁶⁷ *Ibid* p. 3

had increased to USD 140 per barrel⁶⁸. Taking advantage of this price volatility, Triton was able to buy petroleum products and hold them until prices soared above the buying price before disposing of them at a huge profit⁶⁹. The scheme collapsed when international oil prices plummeted to below USD 50 per barrel in November 2008. The company could not sell its huge stocks at KOSF and the imported consignment at a price that would enable it to recover its costs⁷⁰. As a result, the company started experiencing serious difficulties in honouring its financial obligations to financiers and creditors. It not only fell back in payments to these financiers, but was at the same time not able to access the oil it had ordered⁷¹.

While the government has put in place a simplified licensing criteria to facilitate the entry of indigenous persons into the oil sector, little if any, has been done to incentivise those entering the oil sector to invest in petroleum logistics facilities such as storage infrastructure. Indeed, the indigenous persons entering the oil sector have been the main culprits in using the KPC system as a storage/trading tool with Triton Petroleum Limited even going to the extent of abusing the system.

Additionally, due to the capital intensive nature of putting up petroleum storage facilities, the small players who are mostly indigenous OMCs, opt for the cheaper option of accessing storage in the depots or terminals of the big players who are mostly multinational OMCs by paying a throughput or hospitality fee.

3.3.2.2 The Mombasa – Nairobi Pipeline (Line 1)

The Mombasa – Nairobi pipeline system is a 449.9KM long 14 inch diameter pipe and has 8 pumping stations with safe operational pumping capacity of 830M³ per hour⁷². Line 1 is 34 years old having come into operation in 1978 and according to the most recent in-line inspection survey done in 2010, the line is substantially corroded in most sections of the pipeline and requires replacement⁷³. There are plans to replace the entire line with a 16 inch diameter pipeline in order to meet the projected Kenyan demand up to the year 2030⁷⁴.

The replacement of the line is likely to lead to a disruption of supply being that the pipeline is the primary means for transporting petroleum products from Mombasa to Nairobi and onto

⁶⁸ *ibid*

⁶⁹ *ibid*

⁷⁰ *ibid*

⁷¹ *ibid*

⁷² Prof. Albert Mumma: The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 69

⁷³ *ibid*

⁷⁴ *ibid*

Western Kenya. The disruption will most likely lead to greater use of road tankers to move petroleum products from Mombasa to Nairobi. Transportation of petroleum predominantly using tankers causes damage to our roads and is also dangerous owing to the inflammable nature of petroleum products not to mention the damage to the environment in the event of a spillage. Of more relevance to the topic at hand perhaps is the fact that it is more expensive to transport petroleum products through road than through a pipeline⁷⁵.

In the stakeholders submissions to the ERC objecting to the implementation of the Regulations summarised in Annex 2 of the Commission Paper on Petroleum Pricing Regulations Stakeholders Forum, proposals had been made to accommodate, in the price formula laid down in the Energy (Petroleum Pricing) Regulations, 2010, bridging costs from Mombasa to upcountry depots owing to breakdowns in the KPC system⁷⁶. The proposal which was rejected save for transportation of diesel was a ratio of pipeline to road transport of 85%:15%⁷⁷. It is highly likely that any supply disruptions occasioned by the replacement of Line 1 will ignite OMCs to push for the accommodation, in the Energy (Petroleum Pricing) Regulations, 2010, of higher bridging costs for premium motor spirit, regular motor spirit, kerosene and diesel all of which are transported using that pipeline. This will automatically translate into higher prices for consumers of petroleum products.

3.4 Other inefficiencies, challenges and bottlenecks in the petroleum subsector

3.4.1 Import/Offloading facilities in Mombasa

Refined petroleum products and crude oil imported into the country are offloaded at the Kipevu Oil Terminal (KOT) into KOSF and KPRL facilities in Mombasa respectively⁷⁸. A smaller jetty at the Shimanzi Oil Terminal (SOT) is operated by oil marketers for import and export of refined petroleum products but the bulk of the imports (90%) are handled at KOT⁷⁹. KPA's long term plan as stated in the KPA Master Plan is to stop using SOT for handling petroleum products⁸⁰. The overreliance on KOT for offloading oil imports exposes the country to supply disruptions in the case of a catastrophe.

⁷⁵ It costs Kshs. 4.5 per litre to transport petroleum products from Mombasa to Nairobi by road tanker. See the Commission Paper on Petroleum Pricing Regulations Stakeholders Forum p.11 available at www.erc.go.ke/pricereg.doc accessed on 15th July 2011. On the other hand, it costs Kshs. 2.25 per litre to transport petroleum products from Mombasa to Nairobi via pipeline. See the First Schedule to the Energy (Petroleum Pricing) (Amendment) Regulations, 2012.

⁷⁶ Commission Paper on Petroleum Pricing Regulations Stakeholders Forum p.11 available at www.erc.go.ke/pricereg.doc accessed on 15th July 2011. P. 6

⁷⁷ *ibid*

⁷⁸ See paragraph 3.3.2.1 of this Chapter. Also see The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 64

⁷⁹ *ibid*

⁸⁰ *ibid*

The maximum draft at the entrance to the Mombasa Port is 13.5 metres which limits Kenya's ability to import cargoes bigger than 84,000 MT to KOT. For SOT, the maximum ship size is 30,000 MT. The use of many small vessels results in higher freight costs and demurrage⁸¹. These high freight costs and demurrage are ultimately absorbed into the prices of the petroleum products as costs incurred in import and supply further pushing up the price. Moreover the overreliance on KOT means that if one industry vessel is offloading, another cannot dock and offload. The vessel that cannot dock and offload will continue to accrue demurrage without any culpability on either the OMC importing the petroleum products on behalf of the industry, the shipper, KPC, KPRL or the OMCs receiving the products. The draft General Tender Terms and Conditions for the Delivery of Petroleum Crude Oil to Kenya Petroleum Refineries Limited under the merchant mode⁸² acknowledge as much when they provide in clause 13.1 (d) as follows:

“13.1 (d) Where berthing of the Seller's Vessel is delayed by another vessel occupying the berth and discharging Industry Cargo (imported refined petroleum products), demurrage shall be borne by the Industry⁸³ (*emphasis mine*).”

The inability to import cargoes bigger than 84,000 MT does not only lead to higher freight costs but also makes it difficult to obtain the best price for petroleum products based on economies of scale.

3.4.2 Challenges to the Open Tender System (OTS)

Spot buying exposes the country to price volatility and unreliability as opposed to long term supply contracts which come with price stability and reliability. Generally long term agreements present the best terms for securing and procuring reliable supplies of petroleum products⁸⁴. According to statistics, 70% of petroleum products worldwide are procured through long term agreements⁸⁵. The contracts are either through government to government agreements or commercial with national oil companies⁸⁶.

⁸¹ *ibid*

⁸² Draft attached to e-mail sent to the Chief Executive Officers and Supply Managers of OMCs on 17th April 2012 subsequently forwarded to the author on 23rd April 2012.

⁸³ “borne by the industry” means factored into the cost of the products and accommodated in the price mechanism in the Energy (Petroleum Pricing) Regulations, 2010.

⁸⁴ The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 46

⁸⁵ *ibid*

⁸⁶ *ibid*

To achieve competitive terms through long term agreements, the quantities must be substantive to provide economical consignments. The Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010 as amended by the Energy (Importation of Petroleum Products) (Quota Allocation) (Amendment) Regulations, 2012 which mandate NOCK to import 30% of the country's jet fuel and automotive gasoil⁸⁷, do not make up sufficient quantities for competitive long term contracts. Kenya's plan to import 4 million tonnes of crude oil from Iran based on a memorandum of understanding between Kenya and Iran signed in June 2012 faced a major setback when the United States and its western allies threatened trade sanctions against Kenya⁸⁸.

Kenya relies fully on the performance of the winner of the OTS, and is exposed to a default (either for logistical or financial reasons) by the latter⁸⁹. The Ministry of Energy has not implemented a system of financial guarantee by the importer whereby stocks under Collateral Financing Arrangements (CFA) can still be accessed in case of default⁹⁰.

3.4.3 Management of information on prices

The price formula as contained in the Energy (Petroleum Pricing) Regulations, 2010 is not a secret and anyone versed with petroleum supply matters and keen to know whether the price of petroleum products will increase or decrease can, to a reasonable level of accuracy, ascertain what the increase or decrease will be like. The foregoing notwithstanding it is important for the ERC to hold back the announcement as to whether prices will increase or decrease until the actual moment when the prices increase or decrease⁹¹. This is so as to avoid short term supply hiccups owing to service station operators or dealers trying to cut their losses by not placing orders at the OMC terminals if prices are coming down or overstocking if prices are going up. While this does not directly affect the price of petroleum products, in the event of service station operators or dealers not placing orders to avoid having expensive petroleum stocks when a new lower price takes effect, it leads to shortages which invite desperation among consumers. Such desperation may compel them to buy petroleum products from unscrupulous businessmen selling at a price higher than the maximum price stipulated by law.

⁸⁷ See paragraph 2.1.8 of Chapter 2.

⁸⁸ Reuters; Kenya agrees to buy Iran oil, silent on sanctions, available at <http://af.reuters.com/article/commoditiesNews/idAF16E81294E20120702> accessed 8th August 2012. Also see Margaret Wahito; ERC says Iran deal setback won't affect supply; Capital FM Business available at <http://www.capitalfm.co.ke/business/2012/07/erc-says-iran-deal-setback-wont-affect-supply/> accessed 8th August 2012.

⁸⁹ The Energy Sector in Kenya; An overview of the Policy, Legal and Institutional Framework; 2011 p. 46

⁹⁰ *ibid*

⁹¹ See Regulation 3(3) of the Energy (Petroleum Pricing) Regulations, 2010. New prices take effect on the 15th day of each month.

3.5 Conclusion

From the foregoing, it is apparent that the inefficiencies, challenges and bottlenecks associated with the laws and regulations as well as the players in the petroleum subsector contribute in one way or another to the cost of procurement, supply, distribution and retail of petroleum products. As such, there is an urgent need to address these inefficiencies challenges and bottlenecks to bring down the cost of petroleum products ultimately borne by the consumer of petroleum products. While the Competition Act discussed in chapter 2 can be used to tame the margins that oil companies seek to make from petroleum and petroleum products, it cannot address high petroleum product costs in the procurement, supply, distribution and retail chain due to inefficiencies, challenges and bottlenecks in the chain.

CHAPTER 4

CONCLUSION AND RECOMMENDATIONS

4.1 Introduction

The inefficiencies challenges and bottlenecks in the petroleum subsector have been discussed in Chapter 3. What is evident from that discussion is that the approach adopted by the government (that of capping the prices of petroleum products) does not guarantee a good price for consumers of petroleum products. This is so because, as highlighted in that chapter, the inefficiencies, challenges and bottlenecks in the petroleum subsector are directly or indirectly factored into the prices of petroleum products and absorbed by the consumers of petroleum products. Guaranteeing a fair price to consumers would entail addressing the inefficiencies, challenges and bottlenecks in the petroleum subsector. Indeed, the fact that there has not been a significant change of prices of petroleum products (whether by way of an increase or a decrease) since the enactment of the Energy (Petroleum Pricing) Regulations, 2010 should be a testimony that the real issue in the subsector may not have been the absence of competition owing to the oligopolistic nature of the subsector¹. If one adopts this assumption, a conclusion to the effect that in enacting the Energy (Petroleum Pricing) Regulations, 2010, the government opted for a political solution aimed at appeasing the populace to address an economic problem can be justified.

4.2 Conclusion

There does not seem to exist a clear intention by the government to urgently address the issues negatively affecting the petroleum subsector.

NOCK, KPC and KPRL are limited liability companies incorporated under the Companies Act (Chapter 486 of the Laws of Kenya). As such they should, relying on the principle of separate legal personality, determine their own corporate destiny under the guidance of their directors, which destiny, if permitted by the company objects, may but need not necessarily be shared by the shareholder which is the Government of Kenya with regard to NOCK and KPC. With

¹ See paragraph 3.5 of Chapter 3.

regard to KPRL the situation is even more complicated as the Government of Kenya and Essar Energy Overseas Limited each has a shareholding of 50%. Had KPC, NOCK and KPRL been statutory bodies with a statutory mandate, perhaps the government would be in order to set policies for these companies for instance the modernization of KPRL by 2016 and the replacement by KPC of line 1 by 2014³⁶. The Government of Kenya thus seems to be providing for in policy that which the boards of directors of these companies should be deciding on and at the same time indirectly granting these companies a monopoly over the infrastructural developments envisaged in the Draft National Energy Policy.

With the discovery of oil in Turkana County, the government's policy focus has shifted to midstream and upstream activities with little regard being given to the issues affecting the downstream activities. Even the focus on the midstream and upstream activities does not appear to sync well with what is happening within the oil sector in the region. For instance, one of the short term implementation plans of the government under the Draft National Energy Policy is to extend the oil pipeline from Eldoret to Kampala³⁷. This plan exists in the current National Energy Policy crafted in 2004. While it may have made sense in 2004 to extend the oil pipeline into Kampala, Uganda, it does not make sense to do so now with the discovery of crude oil in Uganda unless the line to Uganda is designed to accommodate a reverse flow of products so that when Uganda begins to refine its crude oil, the refined products can be exported into and through Kenya. Prior to the termination of the Heads of Agreement between the Governments of Kenya and Uganda and Tamoil East Africa Limited (TEAL) for the construction of the Eldoret-Kampala pipeline, TEAL had managed to convince the governments to permit it to construct a bi-directional line despite the invitation for tenders having been for a single flow line³⁸. The foregoing notwithstanding, it may not be feasible today to construct a bidirectional pipeline from Eldoret to Kampala owing to the discovery of Oil in Turkana County and the intention of the government to upgrade KPRL and build another refinery in Lamu. As noted in the analysis of the Energy (Petroleum Pricing) Regulations, 2010³⁹ the transport cost or tariff is normally an ingredient in the price of petroleum products. A failure to plan the pipeline infrastructure in such a way that the tariff will be reasonable based on the distance over which the petroleum products are transported to the customers will lead to a hike in prices:

³⁶ See the short term implementation plan in the Draft National Energy Policy.

³⁷ Third Draft of the National Energy Policy dated 11th May 2012 available at <http://www.crc.go.ke/crc/Regulations/National%20Energy%20Policy%20-%20Third%20Draft%20-%20May%2011%202012.pdf> accessed 7th September 2012 p. 42

³⁸ The draft implementation agreement between the two governments and TEAL was amended to accommodate a reverse flow pipeline and TEAL was allowed to revise the pipeline specifications initially approved

³⁹ See para. 2.1.10 of Chapter 2.

With regard to refineries, questions abound as to why the government would want to upgrade KPRL⁴⁰ and build another refinery in Lamu⁴¹ when Uganda is also planning to put up its own refinery. Owing to the capital intensive nature of constructing a refinery, a bigger ultramodern refinery serving Kenya, Uganda and South Sudan is likely to guarantee lower prices of petroleum products.

The government does not seem to have a clear goal on how it intends to use NOCK to stabilize the prices of petroleum products. As noted in Chapter 3, NOCK currently has an import quota of 30% for jet fuel and automotive gasoil⁴² pursuant to the Energy (Importation of Petroleum Products) (Quota Allocation) Regulations, 2010 and the Energy (Importation of Petroleum Products) (Quota Allocation) (Amendment) Regulations, 2012. The objective behind granting this quota is unclear and the Minister of Energy does not have power in law to grant the quota⁴³. Under the Draft National Energy Policy, the government intends to give NOCK a 30% import quota for the entire country's demand of petroleum products⁴⁴. It is not apparent from the policy how NOCK will relate with the other OMCs when it clearly has an advantage in the market in that it will be allocated more ullage/space in the common user storage facilities like KOSF. The allocation of the quota being a short term implementation plan, it is unlikely that the government will have addressed the ullage constrain issues in the subsector to allow ullage to be allocated freely in the common user storage facilities as opposed to it being pegged on an OMC's market share. This lacuna in the policy is likely to lead to a chaotic implementation of this policy plan whose objective is yet unclear.

4.3 Recommendations

The government should in formulating a new National Energy Policy in line with the Constitution, 2010 and Vision 2030 avoid putting objectives in the policy which can better be achieved through legislation, a case in point being the modernization of KPRL. This objective can be achieved by limiting the scope of time within which protection will be afforded to KPRL through legislation. The Petroleum (Amendment) Rules, which compel OMCs to purchase refined petroleum products from KPRL should be amended to include a cut-off date when OMCs will be at liberty to source refined petroleum products from anywhere, the only condition

⁴⁰ Third Draft of the National Energy Policy p. 42.

⁴¹ The Government intends to construct a new refinery in Lamu under the LAPSSSET Project.

⁴² See paragraph 3.2.2 of Chapter 3.

⁴³ *ibid*

⁴⁴ Third Draft of the National Energy Policy p. 42.

being that those products should meet a certain quality standard. The replacement of the Mombasa – Nairobi line by KPC by the year 2014 is another item that should not be contained in the Draft National Energy Policy but in law⁴⁶. In fact, its inclusion in the draft policy can be construed as a perpetuation of an illegality as it allows KPC to continue operating a corroded line that has exceeded its replacement date and is a threat to health and safety not to mention its potential to spill petroleum products and pollute the environment. The National Environmental Management Authority (NEMA) is unlikely to succeed in any attempts to get KPC to stop operating the line if the Draft National Energy Policy is adopted in its current form.

The government should formulate workable policies with an implementation plan that is alive to the existing legal framework, facilities and structures in the petroleum subsector. A clear plan for instance should be formulated on how the government intends to use NOCK to stabilize the prices of petroleum products. In doing this, the government should ponder over the following questions, among others:

1. NOCK being a limited liability company incorporated under the Companies Act (Chapter 486 of the Laws of Kenya) and not a statutory company with a specific mandate of stabilizing prices, can it be used for such a role that conflicts with its profit making objective.
2. Is the government's continued sole shareholding in NOCK in line with its divestiture policy as contained in the Energy Policy⁴⁷ and its policies on public enterprises reforms and privatization?⁴⁸
3. Will NOCK continue to compete in the market with other OMCs for profit and if so what measures will the government put in place to ensure fair competition owing to NOCK's quota allocation among other advantages it will enjoy?
4. Is it necessary to use NOCK to stabilize prices of petroleum products even in the absence of inefficiencies, challenges and bottlenecks and in the presence of healthy competition in the subsector guaranteed by strong competition laws?
5. Will the NOCK Board and Management be allowed to operate independently in the interest of the Company or will they be subject to government control?

⁴⁶ Third Draft of the National Energy Policy p. 42

⁴⁷ The National Energy Policy, Sessional Paper No. 4 of 2004 p. 42.

⁴⁸ See the 1992 Policy Paper on Public Enterprise Reforms and Privatization (Revised 1994, 1998) Summary available at www.pc.go.ke (accessed 18th September 2012)

The foregoing questions only serve to highlight the kind of challenges that the government is likely to face in its quest to use NOCK to stabilize prices of petroleum products. NOCK like any other company is keen to make profits and is unlikely to agree to be used by the government in stabilizing prices in the market if the same entails sacrificing margins unless the government makes a substantial funding of the venture. Moreover, the NOCK board can easily resist attempts by the government to get the company to lower prices of petroleum products below those being posted in the market on grounds that NOCK is not statutorily mandated to engage in the stabilization of prices neither do its objects permit it to. The government should therefore stabilize prices by ensuring that the laws and infrastructure permit the subsector to operate efficiently.

The government should not close its eyes to what is happening in the region with Uganda and Somalia set to join the exclusive group of oil producing countries. Policies for the upstream, midstream and downstream sides of the subsector should be designed to take full advantage of the oil boom in the region. Regional co-operation and planning should be encouraged to avoid wastage and imprudent use of resources without compromising the country's strategic needs and plans.

The government should not take the yield shift lightly. While the provisions of the Mombasa Refinery Processing Agreement appear not to support the claim by the OMCs⁴⁹, dismissing it as a private affair between KPRL and OMCs will not only deter investment in the subsector if OMCs are not compensated for the losses they have incurred but will also lead to a surge in the prices of unregulated products as OMCs seek to recover the losses through those products.

Finally, the government should wake up to the realization that price controls in a liberalized economy cannot serve to tame the prices of petroleum products. Focus should be directed at addressing the real issues perceived to be behind the increase in prices of petroleum products. Already the government has formulated policies meant to address the inefficiencies and challenges brought about by the outdated technology being used at the KPRL refinery. The government has also formulated policies to address ullage constraints at KPC facilities as well as constraints in the transportation of petroleum products. The implementation of these policies should be fast tracked. With the Competition Act, 2010 in force and the same having addressed the weaknesses of the Restrictive Trade Practices, Monopolies and Price Control Act, the

⁴⁹ see para. 3.3.1.3 of Chapter 3

government should strongly consider doing away with price controls in the petroleum subsector and allow the Act to play the role of guaranteeing fair competition among the players in the subsector. Any weaknesses that present themselves during the application of the Act to the subsector can be addressed through amendments to the Act.