TRADE LIBERALIZATION AND ITS IMPACT IN THE OIL SECTOR: THE CASE OF REFINED PERTROLEUM PRODUCTS IN KENYA 1994-2004 7

BY
HELLEN M. GICHURU
R/50/P/8212/02

A PROJECT PRESENTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF ARTS IN INTERNATIONAL STUDIES AT THE INSTITUTE OF DIPLOMACY AND INERNATIONAL STUDIES, UNIVERSITY OF NAIROBI.

NOVEMBER 20113—

DECLARATION

This project is my original work and it has never been submitted to any other university ' for any academic award.

I acknowledge all sources of information referred to herein.

Name: HELLEN M. GICHURU Signature: . t f c w ^ . .

Date: 24th September 2007

This project has been submitted for examination with my approval as a University Supervisor.

Name: Dr. OLOO ADAMS Signature:

Date:

Department of Political Science

University of Nairobi

ACKNOWLEDGEMENT

This study has taken efforts of many people to be completed, but there are those whose persistence, urge and presence immensely contributed to completion of the study. My spouse Gichuru Gaitho and our children Wanjiru and Muthoni who often commented that they expected me to complete my studies soon and little Wamboi who was ever determined to turn my study time to play time. A combination of this and expectation from my family became a driving force for the success of this study.

I wish to acknowledge and express my sincere gratitude to my friends who never tired or lost the opportunity of inquiring of my study progress. To me, this was not only a challenge but an encouragement.

My supervisor, Dr. Adams Oloo, he supported me, his constructive criticism, and encouragement made major contribution to success of this study. His availability and quick response to any emerging academic needs humbled me. I am grateful and thankful for all. I am also grateful to the entire staff of Institute of Diplomacy and international Studies (IDIS) for their support whenever I sought their assistance.

To my colleagues at my work place and Kenya Pipeline Company Management, I do not take for granted your support to throughout the data collection and thesis writing and whenever I needed any assistance; particularly Mr. Andrew Kosgei and Salvador Agina for being available whenever I needed assistance for the study. I am also sincerely thankful to the Ministry of Energy and particularly key informants in the oil industry for their response to my inquiry.

Once again, special thanks to my husband Gichuru Gaitho for his encouragement. His financial, academic and moral support throughout the period of the study will remain treasured in my memory.

TABLE OF CONTENTS

LIST OF ABBREVIATIONS 7

DEFINITION OF TERMS 8

CHAPTER 1 10

1.1 INTRODUCTION 10

1.2 PROBLEM STATEMENT 14

1.3 OBJECTIVES OF THE STUDY 16

1.4 JUSTIFICATION OF THE STUDY 16

(a) Academic Justification 16

(b) Policy Justification 17

1.5 STUDY LIMITATIONS 18

1.6 LITERATURE REVIEW 18

1.7 HYPOTHESES 24

1.8 THEORETICAL FRAMEWORK 25

1.9 STRATEGIC TRADE THEORY 26

1.10 METHODOLOGY 28

CHAPTER 2: 29

PRE AND POST - LIBERALIZATION: AN OVERVIEW OF THE OIL SECTOR IN KENYA (1964-2004) 29

2.1 INTRODUCTION 29

2.2 PRE-LIBERALIZATION PERIOD (1963-1993) 29

2.3 THE POST - LIBERALIZATION PERIOD 1994 -2004 37

2.4 CONCLUSION 44

CHAPTER 3: 46

TRADE LIBERALIZATION IN KENYA: A GENERAL OVERVIEW 46

3.2 THE GOVERNMENT STRUCTURES IN LINE WITH THE LIBERALIZATION 46

3.3 JUSTIFICATION OF TRADE LIBERALIZATION 48

3.4 TRADE LIBERALIZATION: THE EXPECTATIONS 50

3.5 PERFORMANCE UNDER TRADE LIBERALIZATION 51

3.6 LIBERALIZATION OF THE OIL SUB-SECTOR IN KENYA: 52

3.7 CONCLUSION 60

CHAPTER 4 62

A CRITICAL ANALYSIS OF THE RESEARCH FINDINGS OF THE STUDY 62

4.1 INTRODUCTION 62

4.2 TRADE LIBERALIZATION HAS SPURRED LIMITED POSITIVE IMPACT IN THE OIL SECTOR IN KENYA 62

RECEIPT AND DELIVERY CONDITIONS 67

4.2 AN EFFECTIVE LEGAL AND REGULATORY FRAMEWORK IS NECESSARY TO DETER COMPETITIVE PRACTICES IN THE OIL SECTOR 75

CHAPTER 5: 83

SUMMARY, CONCLUSION, WAY FORWARD AND RECOMMENDATIONS 83

5.1 SUMMARY AND CONCLUSION: 83

5.2 SUMMARY OF THE STUDY FINDINGS: 84

5.3 THE WAY FORWARD 86

5.3.1 PURSUING ALTERNATIVE SOURCES OF ENERGY 86

5.3.2 FUEL-SAVING TRANSPORT SYSTEM 87

5.3.3 GOVERNMENT STRATEGIC STOCKS 87

5.3.4 GOVERNMENTS-TO-GOVERNMENT INITIATIVES 88

5.3.5 CONTINUED OIL EXPLORATION 89

5.3.6 AN EFFECTIVE LEGAL AND REGULATORY FRAMEWORK FOR THE OIL SUB-SECTOR 89

5.3.7 GOVERNMENT-LED DEVELOPMENT AND EXPANSION OF INFRASTRUCTURE: 90

5.4 SUGGESTION FOR FURTHER RESEARCH AND RECOMMENDATIONS: 91

BIBLIOGRAPHY 93

APPENDIX I 99

APPENDIX II 100

LIST OF ABBREVIATIONS

1. ERG - Energy Regulatory Commission
2. ENI - Ente Nazionnale Idrocarbur
3. GDP - Gross Domestic Product
4. HSE - Health, Safety and Environment
5. ISI - Import Substitution Industrialization
6. IPDs - Independent Petroleum Dealers
7. IEA - Institute of Economic Analysis
8. IMF - International Monetary Fund
9. KPC - Kenya Pipeline company Limited
10. KR - Kenya Railways
11. KPRL - Kenya Petroleum Refineries Limited
12. KOSF - Kipevu Oil Storage Facility
13. KOT - Kipevu Oil Terminal
14. KIPPRA- Kenya Institute for Public Policy Research and Analysis
15. LPG - Liquefied Petroleum Gas
16. LNG - Liquefied Natural Gas
17. MoE - Ministry of Energy
18. MNCs - Multinationals Corporations
19. NOCK - National Oil Corporation of Kenya
20. 0TS - Open Tender System
21. PIEA - Petroleum Institute of East Africa
22. PRC - Procurement and Refining Cost
23. PMU - Petroleum Monitoring Unit
24. SSA - Sub-Saharan Africa
25. SAP - Structural Adjustment Programs
26. SEP - Single Entry Point
27. USA - United States of America
28. VAT - Value Added Tax

DEFINITION OF TERMS

Definitions

The following are the definitions that have been used in this study:

i. **"Affiliate"** - means a company in which a party holds directly or indirectly more than 50% of the vote-carrying shares, or a company holding directly or indirectly more than 50% of the vote-carrying shares of that party, or a company of which more than 50% of the vote-carrying shares are held directly by a company which holds directly or indirectly more than 50% of the vote-carrying shares of that party.

ii. **"ASEs": Adjustment to Stock Entitlements**

iii. **"Assignee":** A party to which a shipper shall transfer and/or assign its ownership rights of Petroleum products in the System in accordance with the provisions of this Agreement.

iv. **"Batch":** A quantity of Petroleum Products of the same Grade received.

v. **"Delivery":** Quantity of Petroleum Products delivered by KPC at a Delivery Point.

vi. **"Delivery Point":** The point where the custody of a Petroleum Product passes from the System to facilities owned or used by RIVA.

vii. **"Grade":** A particular category or type of Petroleum Product as per the applicable specifications in force from time to time.

viii. **"Interface":** The zone of mixing which develops between two adjacent and different Grades of Petroleum Product as they pass through the System.

ix. **"Kipevu Oil Storage Facility" or "KOSF":** The facility extending from the Kipevu Oil Jetty up to and including the storage tanks and the interconnecting pipelines used for receiving, storage and trans-shipment of Petroleum products.

x. "m^3": Cubic metre equivalent to 1,000 litres.

xi. **"Petroleum Products":** Bulk and unpackaged Motor Gasoline (PMS and RMS), Illuminating Kerosene (IK), Aviation Turbine Fuel (Jet A-1), and Automotive Gas Oil (AGO).

xii. **"Point of Entry":** Upstream face of the valve designated for specific Petroleum Products at the boundary between the System and facilities owned or used by RIVA.

xiii. **"Receipt**":A quantity of Petroleum Product accepted

xiv. **"Storage/ullage":** Safekeeping of Petroleum products at Delivery Points prior to delivery to RIVA.

xv. **"System":** The facilities owned and/or operated by KPC at Mombasa, Nairobi, Nakuru, Eldoret, Kisumu and any other locations together with the aviation fuelling facilities at Jomo Kenyatta and Moi International Airports, and any other airport including all piping and related pumping, receipt, storage and delivery facilities and equipment required for the transportation of a shipper's Petroleum Products between these locations.

xvi. **"Transportation":** Receipt of Petroleum Products by KPC at the Point of Entry, its movement through the System and its Delivery at a Delivery Point.

xvii. **"Ultimate Flow Rate":** The maximum design capacity pumping flow rate of the pipeline.

xviii. **"Benefits:** The gains and advantages (such as increased number of licensed oil marketers, reliability in supplies of petroleum products competition and attracting foreign) derived from liberalization of the oil sub-sector.

CHAPTER 1

1.1 INTRODUCTION

Oil is the most important source of energy in the world. It is indeed a strategic resource in International relations. Oil is the commodity in which the largest multinationals are built. It is a resource that is synonymous with national, military and economic power (Moore&Turner1980). Incidentally, oil was accidentally discovered in the USA in form of methane gas (LPG) by miners while digging for coal in 1873. Since then, there have been several developments in this field resulting in the discovery of many oil wells worldwide. There are large deposits in the USA, Russia, Middle East, Africa and Europe. After this discovery, oil companies were formed to exploit the new opportunity and the world has as a result witnessed the creation of giant multinational oil companies (Balabanis 2001). This basically means that countries endowed with this resource have an edge over those that do not have as will be revealed in this study.

In Kenya, oil contributes about 80% of the total commercial energy consumption. Compared in global terms, the Kenyan oil market is small due to the underdeveloped economy that is heavily dependent on labour intensive and rain agriculture systems (Mecheo & Omiti 2003). The demand for oil stands on average at two and half tons per year, all imported from the Gulf region either as crude oil for processing or as refined petroleum products.

Before the liberalization of the oil sector in Kenya, in October 1994, the sector was marked by a relatively high direct governmental participation and a low level private sector involvement. A total of seven marketing and distribution companies were responsible for procuring and importing their own oil while the National Oil Corporation

of Kenya (100% government owned) was allowed to supply 30% of crude oil into the Country (Mecheo & Omiti, 2003).

The government played a role in the oil industry through; Kenya Petroleum Refineries Ltd (KPRL), Kenya Pipeline Company (KPC), National Oil Corporation of Kenya (NOCK), and Kenya Railways Corporation (KR). The KPRL is owned on a 49:51 holding between the government and three shippers (oil marketers) namely BP/Shell, Caltex and Total who is a minority holder.

In the pre-liberalization period, the government in consultation with the oil marketers set consumer prices for petroleum products. However, beginning October 1994, the procurement, distribution and pricing of petroleum products were liberalized with a view of enhancing operational efficiency and attracting private capital into the sector.

The liberalization process in the oil industry included: -

i. Liberalization of procurement, distribution and pricing of petroleum products in the country,
ii. Abolition of the "white oil rule". This rule required all oil marketers by their individual agreement to process crude oil at KPRL in order to meet the national demand for refined petroleum products. After its abolition, oil marketers were allowed to import refined petroleum products.
iii. Abolition of the 30% quota for NOCK supply into the country,
iv. Liberalization of the oil transportation modes and the attendant tariffs,
v. Legalization of minimum operational stocks of petroleum products,

Introduction of 2% suspended duty on all refined petroleum products imported into the country and finally licensing of independent new companies to engage in petroleum business (Indetie, 2003).

With liberalization, it was envisaged that: -

i. Price impact on consumers would be stabilized
ii. Cartel like grouping would be checked i.e. a level of control would be realized
iii. An enabling environment for new-comers would be created
iv. A wide reach effect for consumers would be created
v. Regional trade would be promoted
vi. Hitherto unexploited opportunities would be tapped
vii. Financial resources would be mobilized towards this trade (Indetie, 2003).

Liberalization encouraged the entry of new companies to trade in oil a long side the traditional (usually multinational companies) oil marketing companies. However despite the new entrants, only a small number of the independent oil dealers import crude oil for processing at KPRL, as well as engage in oil product distribution. The majority purchase crude oil and refined products at a high premium from the already established oil marketers (Shell BP, Total, Mobil, Caltex, and Kenol-Kobil) for reselling. This has therefore, given rise to proliferation of middlemen agencies and defiance to compliance to regulations in the industry.

In essence the new players have failed to make a major impact as far as competitive pricing is concerned in the oil industry. This could be partly due to inherent institutional and structural barriers that characterize oil trading in Kenya as well as the absence of effective legal and regulatory framework to guide the industry players in a liberalized

market, which are consistent with international norms (Adepoju, Aderanti 2000). Adepoju (2000) further observes that real and perceived corruption and quasi-corrupt practices in the sector has contributed to failure to meet the expectations. Consequently, these factors have combined to deny the economy the inherent gains of a free market and competitive pricing of petroleum products.

The expectation that liberalization would allow entry of more players and hence intensify competition has remained illusive. Though more players have gained entry into the sector, the domestic market still has characteristics that foster the rise and sustenance of a cartel like behaviour; in fact, it is doubtful whether the market is necessarily more competitive than it was before liberalization (Adepoju, Aderanti, 2000).

The oil industry in Kenya has characteristics of oligopoly on account of the relationship between the firms and their collective action in respect of new entrants (Aderanti, 2000). This has hindered the rise of competitive pricing and as such the major oil marketing companies have continued to wield considerable market power.

An oligopolistic market structure is characterized by price leadership by major market players. Price leadership is the most common anti-competitive and consumer exploitative behaviour. It encompasses firms with well defined market share who take turns to raise prices with the result that other firms follow suit without attempting to take advantage of the price hike to increase market share (Adepoju & Aderanti 2000). This practice has two adverse effects.

First, the market prices reflect corporate strategies and the bargaining power of the individual market players that is, prices are not market determined. Second, oligopolistic markets show higher profit margins than a more competitive situation would allow. This has got implications; it is therefore in the interest of major oil marketers to tighten market entry through effective behavioral barriers. Oil companies in Kenya make higher profits on account of the market structure than a more competitive market situation would allow (Boubakri and Cosset 2002).

The policies of liberalization have been developed around the central principle of the superiority of the market over the state. However, in the face of market failure what needs to be done? (Boubakri and Cosset, 2002) contend that if the market is uncompetitive, liberalization/privatization merely transforms public monopoly into private monopoly. In the absence of an appropriate regulatory structure, the private monopoly has adverse effects, where benefits are privatized while imposing costs on society.

This study seeks to investigate the impact of trade liberalization in the oil sector in Kenya for the period 1994 - 2004. It further seeks to establish why the anticipated benefits of trade liberalization have not been realized in the oil sector in Kenya.

1.2 PROBLEM STATEMENT

Oil is a central factor in determining production and transportation costs. Any price increase usually triggers similar trends in virtually all sectors of the economy normally with negative consequences like inflation. The oil sector was liberalized chiefly to improve operational efficiency, attract private capital and increase consumer welfare.

However, available empirical evidence indicates that the oil sector is far from meeting these goals.

A decade after the implementation of trade liberalization, there appears to be little impact in the oil sector in Kenya as far as the above goals are concerned. Trade liberalization has not ensured competition in the oil sector. Yet the centrality of a well functioning oil sub-sector to the overall performance of the economy cannot be underrated.

The impact of new players in regard to competitive oil pricing has been insignificant due to absence of effective legal and regulatory framework to guide the industry players in a liberalized market, thus the economy has to bear with volatile prices usually on an upward trend. With liberalization in 1994, consumer expectation was that there would be more local players with new entrants and the ensuing competition would translate into a reduction in consumer prices. This has not been the case even with the entry of 110 licensed oil companies up from seven before liberalization. In fact, the oil companies argued that the higher prices were necessary to recover lost profits in the period leading to liberalization.

The oligopolistic structure in the oil industry has supported a cartel like market behaviour in determining petroleum products prices since the advent of market liberalization. This can be termed as a case of market failure.

This study attempts to establish whether trade liberalization in itself translates into competitive product pricing and whether the consumer has benefited from oil

liberalization or if there is a need to explore other means to make the sector more competitive.

1.3 OBJECTIVES OF THE STUDY

The following objectives will guide this study.

- First to investigate the impact of trade liberalization in the oil sector in Kenya
- Second to investigate what responses the government and other institutions have undertaken to ensure competition in the oil sector in order to protect the consumers from market exploitation and
- Third to make policy recommendations.

1.4 JUSTIFICATION OF THE STUDY

This study has both academic and policy justifications.

(a) Academic Justification

The findings of this study will enrich the limited existing literature on trade liberalization in the oil sub sector in Kenya and trigger a basis for further research in related fields. In the energy sector, petroleum adds the highest values in the production process and yet locally generated consistent data for specific period of time is limited or lacking due to poor documentation of data and also refusal to provide information by the multinational marketers of these products. In addition, other transporters/ dealers like road, air and water have no organized method of recording keeping for the industry activities other than as individual dealer. Further; that petroleum industry has the least amount of documentation or data. This may be attributed to the level of secrecy attached to dealership in petroleum products, which may guide further demand. Marketers of these products have historically been a cartel-like business industry of about seven

multinational corporations, who have the ability to withhold data or information related to oil production and marketing under the pretext of company secrets. Dealers in these commodities prefer to maintain some secrecy and behind that, outright refusal to give out information. This has resulted in inaccurate data for some years and ultimately in some, inconsistencies in data for specific periods of time (Senga et al 1980, Kiprra report, 2007). In this regard, the study will also be a reference to other studies that will be conducted later.

(b) Policy Justification

There is limited research on this study that has sufficiently addressed how the government is to surmount the institutional and structural weaknesses that impede competition in the oil sector.

The oil sub sector is extremely important to the economy and should not be entirely left to the variance of the market. Hence the need for constant consultation, proper and organized method of record and data keeping and retention by units involved in petroleum activities (i.e. refining, transportation, wholesale and retail services). The Kenya Central Bureau of Statistics (CBS), Kenya Revenue Authority (KRA), Kenya Pipeline and Kenya Petroleum Refineries Limited should maintain records to help them assess economic activities when measured against certain parameters. Such records and data will be a source of reference to come up with improved policy options to address the challenges and consolidate the gains in the oil industry. To this end, the study will offer some policy recommendations.

1.5 STUDY LIMITATIONS

Given that liberalization in the oil sector is a recent phenomenon (began October 1994) there is limited organized locally available data as well as academic literature. As a result, petroleum industry has limited credible sources of documented information due to its historical cartel-like business operation of about seven multinational corporations who have the ability to deny access to oil related information. This may be attributed to the level of secrecy attached to dealership in petroleum products. Marketers of these products have historically been a cartel-like business industry of about seven multinational corporations, and have had the ability to withhold data or information related to oil production and marketing under the pretext of company secrets. Dealers in these commodities prefer to maintain some secrecy and behind that, outright refusal to give out information (Komiyama, 2006, IPAR, 2005). Hence the study will draw from different sources such as articles in the journals, newspapers, magazines, Government Published and administrative unpublished documents from Kenya Pipeline Company Limited (KPC), Central Bureau of Statistics (CBS), Kenya Petroleum Refineries Limited (KPRL), and National Oil Corporation of Kenya (NOCK) and the Internet sites.

1.6 LITERATURE REVIEW

The literature review is presented in two parts, part one briefly covers literature on trade liberalization in general while part two deals specifically with liberalization in the Kenyan oil sector.

According to Reinhart et al (2003), by the late 1980s and early 1990s due to rapidly deteriorating economic conditions, many countries in Sub-Saharan Africa (SSA) undertook far reaching economic reforms under the auspices of the World Bank and

International Monetary Fund (IMF). These countries were to restructure their economies in order to achieve private sector led growth through a market based system. Trade liberalization was a significant component of these reforms.

Bennell (1996) argues that liberalization has been a key feature of all national economic reform programmes in Sub-Saharan Africa. The centrality of liberalization in the process of economic reform in SSA notwithstanding, no detailed empirical research has ever been undertaken on impacts of liberalization in the continent as a whole. In SSA, no single country can be singled out as a very successful privatiser the same way as Chile has been in South America. Liberalization itself as a process is driven by powerful international financial institutions and the main bilateral donor agencies.

Boubakri (2002), arguing in a similar line, posits that Africa has witnessed increasing privatization/liberalization programmes but it is debatable if these programmes have produced gains for the society. According to Boubakri, privatization raises three vital issues i.e. governance, market structure and governmental regulation and incentive systems where structures must function before gains can be realized. If the market is uncompetitive and has a weak regulatory framework, privatization merely transforms public monopoly into private monopoly. In the absence of an appropriate regulatory structure, private monopoly has adverse effects where benefits are privatized while imposing costs on society (Boubakri, 2002).

Bienfield (1994) has argued that the neo-liberal orthodoxy that dominates the international financial institutions and the new world order contend that deregulation of markets and prices, scaling down the role of government and trade liberalization would appear like ingredients for enhancing efficiency and welfare. However, the fact is that

few of the specific policy instalments that make up the neo-liberal policy package enjoy strong empirical support. A point well reinforced by Han-Joon Chang is that empirical evidence on the effect of privatization, and trade liberalization continues to be sketchy and anecdotal.

Khor (2000) posits that many developing countries complain that trade liberalization has negative results to their economies yet it is touted to be positive for growth and development. One of the key things to appreciate about trade liberalization is that if it is imposed upon countries that are not ready, or able to cope, it can contribute to a vicious cycle of financial instability, debt and recession.

If the conditions for success are not yet present in a country, then to proceed with " liberalization can lead to specific negative results. Khor (2002) concludes that developing countries such as Kenya should have the ability, freedom and flexibility to make strategic choices in finance, trade and investment policies where they can decide on the rate and scope of liberalization (Khor, 2002).

When the petroleum sector was de-regularized, expectations were high that operational efficiency would improve and bring about realignment of the market structure and facilitate competition by removing behavioral and structural barriers to entry. This way, the country would benefit from product availability in addition to stable and competitive pricing in a free market which would translate to enhanced consumer welfare (IPAR, 2005). However, it is now more than 10 years and critical questions are being raised on the operations of the oil sub-sector market. Some maintain there have been some positive gains as far as guaranteeing reliability in supply is concerned unlike the days of control when shortages were rampant. Others disagree arguing that nothing much has

changed in the oil sector and that competition is insignificant just as it was in the control era, an oligopoly (Indetie, 2003).

Since liberalization, many new companies have been licensed to engage in petroleum trading, especially import and export, wholesale and retail of refined petroleum products. However, despite this initiative, only a few new entrants are actively trading with a market presence of less that 10% of market share due to tariff and non-tariff barriers to entry. In addition, due to capital outlay required for importation of petroleum products into Kenya, only six to seven new multinationals entrants have been able to penetrate this particular segment of the industry. These few that were able to penetrate constitute less than 6% by volume; this means that there is no real threat or impact to the multinational importers with established markets and infrastructure (Mecheo and Omiti, 2003).

Shaw (1998) while appreciating the importance of the petroleum sector to the economy and its effect to other sectors exonerated the oil companies from the un-competitive nature in the oil sector. He maintains that if anything, deregulation has ensured reliability in supply and that the government needs to do more by upgrading the Mombasa Refinery with the idea of making Mombasa a major oil port. He further says that the government requires constructing facilities in Mombasa and Nairobi to handle imports of liquefied petroleum gas (LPG), and facilitate private sector involvement. While the contention that the government needs to do more to ensure competition in these vital sector is in order, it is incorrect to exonerate the oil marketing companies from distorting competition in the sector as Shaw et al would like to argue. There is empirical evidence that the major oil marketing companies had made entry of new players into the sector difficult even long before deregulation in 1994.

In the mid 1970s (Barry, 1978) observed that the investment in small market oriented refineries was an aspect of market defense strategies of the major companies to defend their dominant positions in highly oligopolistic national markets. The major oil companies' (hereafter referred to as shippers) motivation in investing in refineries was to achieve a potential for market control. Whatever the level of benefit accrued realistic opportunities for substantial further benefits were predetermined. It was against this background that oil shippers such as Shell, BP, Caltex and the government of Kenya on a 50:50 equity holding built the Mombasa Refinery (KPRL). When an Italian oil company Ente Nazionnale Idrocarbur (ENI) expressed interest to enter the Kenyan market it had nowhere to refine its crude oil imports as Shell, BP and Caltex could not allow the company to refine at the Mombasa Refinery (Kapliansky, 1978).

Even before 1994, the oil industry was controlled by seven companies that formed and managed effective cartel like grouping which colluded frequently to further their interests. Senga et al (1980) argued that whenever the oil industry felt the costs had substantially risen to affect profits, the cartel submitted proposals for increases in the prices of petroleum products to the treasury. All the seven companies (Shell/BP, Esso, Caltex, Total, Agip and Kenol) made their submissions concurrently. Thus by acting in cohort (Economic Review Jan. 1998) they wielded a lot of influence and managed to push the prices they proposed through. Senga et al (1980) warned that Kenya would find it difficult to plan effectively for the countries development because of susceptibility to external destabilizing forces and therefore suggested that the country needed to pursue alternative sources of commercial energy. This has come to pass in the era of liberalization with volatile prices in the oil sector.

Indetie (2003) argues that the impact of new players into the oil industry has been minimal due to the absence of effective legal and regulatory framework consistent with international norms to guide the industry players in a liberalized market. Hence the Kenya economy has been denied inherent gains of a free market and competitive pricing of petroleum products (Report by IEA, 2000). There is then a need to review the existing legal and regulatory frameworks and implement policies aimed at eliminating all tariff and infrastructure barriers to entry into domestic oil business. Though Indetie (2003) has outlined the problems facing the oil sector and the diminished impact of new entrants, he has not outlined those policies that the government needs to implement to ensure smooth operation.

Like indetie (2003), a report by the Institute of Economic Affairs (2002) points out similar shortcomings and also anticipated expectations of a liberalized industry that would allow entry of more players and hence intensified competition. However, this did not happen as the domestic market still has characteristics that foster the rise and sustenance of a cartel like behavior. The oil industry has traits of an oligopoly on account of the relationship between the firms and their collective action in respect of new entrants. Whereas liberalization permitted the entry of other foreign and local firms into the oil market, the prevailing conditions indicate that the sub sector is unlikely to be less concentrated.

Mecheo and Omiti (2003) contend that ineffective regulation of the oil industry has seen uncompetitive trade practices in the sector. The entry of new players not withstanding, only a small number of dealers import crude oil for processing at KPRL or even engage in product distribution. A majority purchase crude oil and refined product at a high premium from the already established oil markets (Shell/Bp, Total, Mobil, Caltex, and

Kenol-Kobil) for reselling. As a result the new players have failed to make a major impact in the oil industry courtesy of the inherent institutional and structural barriers to entry into oil trading in the country. For example, the capital intensive nature of investment in the petroleum sector, lack of petroleum truck loading facilities in the major market zones, lack of LPG filling infrastructure therefore leaves the entire LPG market to established marketers, uncompetitive and restrictive trade practices by the established oil marketers (Mecheo & Omiti, 2003).

From the reviewed literature, it is evident that trade liberalization in the oil sector has neither engendered competition nor increased consumer welfare. There is unanimity among the various scholars that the market is uncompetitive with an oligopolistic structure. Yet at the same time few scholars have attempted to provide alternatives on how the government can ensure competition and increase consumer welfare. The few (e.g. Mecheo & Owiti 2003) that have given alternative options have not done so exhaustively. This study seeks to bridge this gap by offering policy recommendations to surmount the problems in this vital sub-sector and to supplement those already available which are purely economic.

1.7 HYPOTHESES

This study will be guided by two working hypotheses.

- Trade liberalization in the oil sector has had limited benefits in terms of increased number of licensed oil marketers competitive market pricing and attracting private capital investment in the oil sector in Kenya.
- Legal and regulatory framework is inadequate to discourage perceived unfair competition practices in the oil sector.

1.8 THEORETICAL FRAMEWORK

This study will be guided by liberalism and its variant neo-liberalism. and strategic trade theory to explain the process of liberalization in the oil sector in Kenya. Liberalism and neo-liberalism are both founded on the free market logic that society will progress if the state is restrained from playing any direct role in the allocation of resources. Both theories are characterized by the following key tenets;

i. Support market oriented development strategies.
ii. Recommend minimal role for the state
iii. Free trade
iv. Emphasis on comparative advantage
v. Financial discipline
vi. Prosperity through economic growth.

However empirical evidence has indicated the vaunted superiority of the market over the state is not unmitigated case of success. Excessively unregulated markets have tendency to create price instability and profit margins that border on fraudulence towards consumers (Bienfield, 1994).

Liberalism and neo-liberalism have not provided recourse in cases of market failure such as pollution or even some economic sectors like energy distribution which are natural monopolies. Economic activity in these fields requires huge capital investment that when one or a few firms are in place, they can manipulate prices so as to reap high profits and simultaneously prevent entry of other competing firms.

1.9 STRATEGIC TRADE THEORY

Advocates of strategic trade theory see it as a means of ensuring that nation's industries remain competitive. Classical international trade theory shows how international trade contributes to the welfare of trading partners. Classical International Trade theory attributes the basis for trade to underlying differences among states (Kegley & Wittkoff, 1993).

Strategic trade policy seeks to create comparative advantage by enlisting government support toward particular industries such as petroleum due to the values it adds in the production process. The argument for selected intervention is due to imperfect competitive markets and/or market distortions. In such cases, it is often possible to identify appropriate targeted trade policy (selected intervention) that can raise aggregate in economic efficiency (Kegley & Wittkoff, 1993).

Although free trade need not always be best policy choice in maximizing national welfare, there are examples in trade literature which demonstrate that selected government intervention has improved the living standards of the citizens. This free trade though touted, as the best policy to maximize economic efficiency can only be effective on assumption that markets are perfectly competitive (Kegley, 1993).

However, the real world is replete with examples of market imperfections and distortions, which include production taking place with monopolistic or oligopolistic firms making positive profits. Strategic trade theory is relevant to this research problem as it acknowledges that a state can intervene in the economy to maximize national welfare.

Liberalism and neo-liberalism in the study will show that the state can subtly protect the consumers from market variance by supporting market oriented development strategies channel through government parastatal. As will be seen later in this study, parastatal like KPC which provides free truck loading facilities and construction of LPG facilities and Nock bulk which handles bulk purchases, loading facilities and petroleum outlets to independent dealers. These among other government funded projects if properly managed would enable Independent Oil Dealers create competition in the industry. Through such arrangement, the state plays a minimal role but contribute significantly to the decision in the industry.

However, evidence points out that state intervention and protection of the national economy is sometimes necessary despite emphasis on liberalization. The US, European Union and Japan have liberalized their markets and competition is a reality in their economies but they do support large corporations or sectors in difficulty, (openly in US, subtly in Europe and Japan). They defy liberalism with subsidies, and monopolies for certain goods.

The Strategic trade policy seeks to create comparative advantage by enlisting government support toward particular industries such as petroleum due to the values it adds in the production process. The argument for selected intervention is due to imperfect competitive markets and/or market distortions. In such cases, it is often possible to identify appropriate targeted trade policy (selected intervention) that can raise aggregate in economic efficiency (Kegley & Wittkoff, 1993). However this will be fully viable through strict financial discipline in these institutions.

1.10 METHODOLOGY

This study will draw from both primary and secondary sources.

a) Secondary Sources

Secondary data will be collected through library research from sources such as academic papers, journals, and government documents from the Ministry of Energy, Newspapers, Textbooks, and Magazines.

b) Primary Sources

This will be collected through interactive interviews with the Independent Petroleum Dealers Association, officials in the ministry of Energy especially the petroleum monitoring unit, Petroleum Institute of East Africa as the organization that represents the interests of the oil companies, officials of the National Oil Corporation of Kenya (NOCK), and Kenya Pipeline Company.

CHAPTER 2:

PRE AND POST - LIBERALIZATION: AN OVERVIEW OF THE OIL SECTOR IN KENYA (1964 - 2004)

2.1 INTRODUCTION

This chapter looks at the oil industry in the pre and post liberalization periods to compare the situation during the two phases. It further seeks to establish the key players in the oil industry and the government involvement in pre and post liberalization period. In this chapter, we shall establish whether the expectations that a genuinely competitive pricing regime would emerge from a liberalized industry and that consumer welfare would be enhanced as a result of competitive prices determined by the market.

In addition, from a political economic perspective, it seeks to establish whether there is need to create economic space in which states can play active roles in guiding economies and under which circumstances states need to intervene even in a liberalized scenario. A comparative analysis of the two phases which will be done at the conclusion of this chapter will determine the gains made or the impact of a liberalized oil industry in the economy.

2.2 PRE - LIBERALIZATION PERIOD (1963 -1993)

By the end of the Second World War there were four companies marketing oil products in Kenya namely, Royal Dutch Shell, BP (British Petroleum), Stanvac and Caltex. Although market shares varied between the product groups, Shell had about 50% of the market share while Stanvac and Caltex had 25% each (Petroleum Insight 2005).

The oil products were imported into the terminals of these companies at Mombasa and then railed upcountry to a network of depots. The wholesale price of products was determined by taking a posted Mombasa price, adding rail freight to the depots, and delivery charge. At independence there were a total of eight private oil companies (Shell, Bp, Esso, Mobil, Caltex, Total, Agip and Kenol). These companies had intense competition and a lot of marketing power struggle (Petroleum Insight 2005). The development of the Mombasa refinery was started immediately after independence by the private oil companies to serve the Kenyan and Ugandan markets. Crude oil was imported and petrol, kerosene (including aviation spirit), diesel, asphalt and LPG were refined from the refinery. The resulting surplus of fuel oil was exported as bunker fuel. In 1971 the Government of Kenya negotiated the purchase of 50% equity in the Mombasa refinery; this marked the first direct involvement by the government in the oil industry.

(a) Government involvement in the Oil Sector

Initially, the government's presence was in the area of policy and regulation. However, in 1973 the government under the Ministry of Energy incorporated Kenya Pipeline Company Limited (KPC) under the companies Act Cap 486. The company's core mandate was to transport, store and dispense refined petroleum products from Mombasa to the hinterland and the neighboring countries through a pipeline. The company started commercial operations in 1978 and it was expected that it would safely and efficiently offer services while easing transportation pressure on the road.

In the pre-liberalization period there was high government participation in the oil industry and a relatively low level private sector involvement. The Kenya Pipeline Company, Kenya Petroleum Refineries Ltd, Kenya Railways Corporation and National Oil Corporation of Kenya represented the government's presence in the petroleum industry. During this period prices of petroleum products were under direct control of government. The government in consultation with the oil marketers set consumer prices for petroleum products. However, the oil marketers formed an effective cartel like grouping which colluded frequently to safeguard their interests. As Senga posits whenever the oil marketers felt the costs had gone up enough to affect profits substantially, they submitted proposals for price increases on petroleum products to the treasury (Senga et al 1980). These submissions were concurrently submitted by all the shippers and thus had an upper hand in their negotiations on whichever issues they felt was affecting their business operations.

Prior to liberalization, the multinationals dominated the industry. Their total market share was 100% shared between the following shippers:

Table!. 1: Shipper's Product Share Cubic Meter (Cu. M) 1990/1991

SHIPPER	MSP	MSR	KKRO	AGO	JET/AI	TOTAL	%
Agip	28.683	27,730	26,136	80,262	27,436	190,247	1 0.00
Caltex	52,781	46,583	44,781	106,993	75,707	326,844	17.17
Esso	47,389	35,735	28,531	82,296	50,515	244.464	12.85
Kenol	3,549	9,158	6,519	16,065	-	35,290	1.85
Total Oil	91,003	30,607	44,005	125,484	18,853	364,405	19.15
Shell	100,162	72,126	48,737	186,925	68,707	569,175	29.91
Kobil	17,480	25,072	21,445	63,946	42,141	172,614	9.07

Source: KPC Statistics Bulletin 1992

I. MSP - Motor Gasoline Premium

II. MSR - Motor Gasoline Regular

III. KERO-Kerosene

IV. AGO - Automotive Gas Oil (Diesel)

V. JET/AI - Aviation Turbine Fuel

*There were no Independent Oil Dealers before liberalization.

In the last half of the 1980s the heavy state intervention in the economy was under attack by institutions like the World Bank and IMF that advocated for a minimal role for the state in the economy. The international system was equally undergoing change with the end of the Cold war in 1989-1990 and the triumph of Western Liberalism as an ideology. A majority of SSA countries started to implement liberalization programs in the various sectors of the economy under the tutelage of the twin Brettonwood institutions and main bilateral donors (US, Britain, Germany, Nordic countries).

In late October 1994 the procurement, distribution and pricing of petroleum products were liberalized with a view of increasing registered marketers, increase in independent oil dealers, rise of the distributor segment, enhanced operational efficiency that would curb petroleum product shortages and attract private capital to the oil industry. The government was to ensure that the oil companies adhered to the tenets of free market competition in arriving at the prices they charge. The key argument was that liberalization would open up the industry and intensify competition and consumers would benefit in terms of price reduction and efficiency.

The Weekly Review (Nov. 1994) observed that immediately after deregulation of the oil sub-sector, reform in this sector would be achieved. However, Weeks after pump prices were decontrolled, prices remained the same in all marketing outlet. The oil industry lobby argued that consumer prices could not be reduced to reflect the strength of the Kenya shilling against the dollar which is the benchmark for international oil trade.

The liberalization of the sub-sector did not deter the upward trend of prices. Rather than benefiting from low or stable prices of petroleum and related fuel products, consumers had to pay more. In 1996 fuel prices were up three times (weekly Review, Oct. 1996) and the oil firms attributed the increase to the rise of the price of crude oil in international market.

It was reported in Economic Review (Jan. 1998) that local oil companies always made un-proportional reduction of prices when compared to international oil prices. For instance in November 1997, international cost of oil was 15 dollars a barrel, the lowest price in three years but elicited a marginal reduction of one shilling by most of the

companies. Crispus Mutitu (then permanent secretary in the Ministry of Energy) claimed the price of Murban crude oil (the variety imported most into the country) had dropped by 5.12 dollars a barrel in November 1997, local oil companies were reluctant to pass the benefit to consumers taking more than two months or longer than the delivery of consignment from Abu Dhabi to the retail station.

Kisero (Sunday Nation, June 2004) posited that the oil market is far from perfect. In fact the office of the Commissioner of Monopolies and Restrictive practices launched an investigation into the industry operations and the effect of oil marketing in a liberalized market. Though there is a massive entry of local players into the oil market, they only control a market share of 15-18% (Indetie 2003) and their imports are negligible to force the established shippers into a price war that can benefit consumers. Improper flow of information also impedes competition; this works better where consumers have full information on available prices.

Research indicates that an oligopolistic situation has emerged in the petroleum sub-sector in which a couple of companies act as leaders and set the prices, while the rest adopt the same price levels after a certain time interval (Oketch and Nyoike 1999). The practice of price leadership vitiates the founding tenet of trade liberalization which is that imposed prices irrespective of who does the imposing are not in the long term interest of the country and society (Oketch & Nyoike, 1999). The government has been unable to intervene against price leadership because it has not equipped itself with adequate legal and punitive measures nor built up an effective capacity to implement the provisions of, for example Restrictive Trade Practices, Monopolies and Price Control Act of 1989. The hope that a genuinely competitive pricing regime would emerge from liberalization and deregulation remains unfulfilled.

At independence, Kenya, like most of SSA countries was heavily involved in matters of the economy. It therefore pursued a pro-capitalist development path aimed mainly at the maximization of economic growth. Two years after independence, the government published the sessional paper No. 10 titled *African socialism and its application to planning in Kenya I3B5* which was meant to chart the development strategy for the new regime. Though it described itself as "African Socialism" the adopted development strategy was in practice managed capitalism or mixed economy whose purported objective was the achievement of social justice (Ndulu & Mwega, 1994). The economic system adopted was by no means a laissez faire, as the inherited state ownership and control apparatus was nurtured and extended after the independence in such areas as prices and wage controls, industrial protection, and agricultural marketing (Ndulu & Mwega, 1994).

The oil industry during the immediate post independence period was in the hands of the private sector just as it was during the colonial period. It was considered important to be left entirely in the hands of the private sector dominated by the multinational companies when the call for "Africanisation" of the economy was dominant. This arrangement was bound to change as the government gradually made inroads into the sector (Indetie, 2003).

During the pre liberalization period the government in consultation with the oil market used to set consumer prices. The fixing of prices for petroleum products was done on the basis of variables related to supply and distribution costs. The Procurement and Refining Cost (PRC) was and still prevails as it is the most influential and dominant parameter in the derivation of prices of petroleum products (Mecheo & Omiti, 2003).

Following the deregulation of petroleum procurement and pricing, the key parameters were exchange rates, cost of crude oil and products, and the product margins based on the import parities of products sourced mostly from the Mediterranean market and to a small extent, the Persian Gulf region (Mecheo & Omiti, 2003).

Besides the price regulation role, the Kenya Railways Corporation (KR) was exclusively owned by the government and it was the mode of transport for the Oil Companies from Mombasa to the hinterland. The transport charge by KR was also a factor in the retail price. In 1971 the government negotiated for a 50:50 equity ownership between the corporation and the oil companies. By 1980 the government's presence in the oil industry was through price control, KR and KPC.

In the early 1980s, the National Oil Company of Kenya (NOCK) was formed and mandated to supply 30% of the crude oil requirement into the country. NOCK was expected to develop solid petroleum trading market shares in order to ensure reliability in supply and stability in retail prices in the country. To achieve this goal, it was allowed access to the petroleum development levy for development of retail infrastructure (Indetie 2003). The rationale was that due to the strategic and sensitive nature of the oil industry, it would be imprudent to leave oil trading entirely in the hands of the private sector. It was envisaged that the corporation would be properly managed and therefore represent the government and to a large extent the society against unfair oil pricing.

It is notable that during this period the oil sub-sector was not very competitive since the government played a leading role in the industry and therefore, the multinational oil companies' leaders could not exploit the situation as they deemed. The entry barriers equally made it difficult for the indigenous oil dealers to offer competition to the already

entrenched oil multinationals. The heavy capital and infrastructural investments were a real impediment; equally the new entrants had to contend with storage and loading facilities usually controlled by established oil marketers.

In a nutshell the pre liberalization period was marked with stability in oil prices and inflation given the linkages between the petroleum sector and other sectors of the economy. Any changes in the petroleum sector tend to affect other sectors. The oil industry was characterized by irregular supply and during this period shortages in supply were rampant. However, this was a minor problem, the interests of the consumer were relatively protected and national welfare enhanced unlike the post liberalization period which is characterized by price volatility.

2.3 THE POST - LIBERALIZATION PERIOD 1994 -2004

(a) The Situation in a Liberalized Oil Sector

The end of the Cold War had ramifications on SSA. Before 1989 and the subsequent collapse of the former Soviet Union individual African states could resist demands for economic and political reforms by playing one superpower off against the other. With the end of the Cold War these options no longer existed (Barkan, 1990).

At the beginning of the 1990's Kenya was at an impasse with the IMF, the World Bank, and major bilateral donors. The donors suspended "quick disbursing" program support amounting to 350 million dollars until Kenya implemented various economic reforms (Ndulu & Mwega 1994). Due to the donor pressure as well as demands from within, the Kenya government moved towards industrial and trade liberalization.

It is against this background that the government found itself retreating from the petroleum sector. Following price and supply deregulation the petroleum sector underwent almost full liberalization in late October 1994. The government participation has remained in the form of policy formulation and investments in supply and infrastructure owned by KPC, the KPRL and NOCK. The government decided to let the petroleum sector operate on the basis of the free market principles without interference in their commercial operations. The government remains a provider of an enabling environment for the sector while providing restricted state investment and control to those infrastructures that the private sector investment may perceive as unviable, unattractive or in restraint of competition (Oketch & Nyoike, 1999).

At the advent of liberalization in 1994, the multinationals still dominated the industry and just like during the pre-linearization, their total market share was still 100% as demonstrated by the table below.

Table2.1: Shipper's Product Share Cubic Metre (Cu. M) 1994/1995

Shipper	Volumes (m^3)	% share
SHELL	486,179	26.0
CALTEX	459.088	24.5
TOTAL	324,276	17.3
AGIP	197,872	10.6
ESSO	189,986	10.2
KOBIL	172,022	9.2
KENOL	42,150	2.3
Total	**1,871,573**	**100**

Source: KPC Statistics Bulletin 1994/95

*Despite the fact that local dealers were aware of the intended liberalization, the industry was still wholly dominated by the multinational corporations.

However, the government retains the responsibility of ensuring the security of supply of petroleum products. In this respect, the Ministry of Energy still has some control of marketing operations through regulatory management under the Essential Supplies, Imports and Exports Act of the Laws of Kenya. Through this Act the government requires the oil companies individually to stock minimum operational stocks of each product equivalent to 30 days consumption and ten days for LPG. A special petroleum monitoring unit was set up by the Ministry of Energy in 1994 to monitor supplies.

To ensure that the country gets the most competitive price, all product imports for the local market are sourced through an OTS which enables competitive tenders for the supply of crude and refined fuel to the market. Participation is limited to the existing oil marketing companies including NOCK. Importation of crude oil and refined products is

coordinated by an industry committee chaired by KPRL and the current oil marketing companies the Ministry of Energy being in charge of oil and energy policy is also represented in this committee. The committee's primary function is to program the importation of crude oil and refined products in order to ensure sufficient supply to the market.

The deregulation of the oil industry in Kenya is classified into seven main sectors namely:

i. Inland: this encompasses the retail sector which includes all service stations and distribution by dealer and commercial sector make bulk sales to industries and other end users.
ii. Aviation: sale of jet oil and related products to the aviation industry.
iii. Trading: Sale of petroleum products from one oil company to another oil company.
iv. Export to neighbouring countries
v. Liquefied Petroleum Gas (LPG) and
Lubricants

All the above entailed liberalization of procurement, distribution and pricing of petroleum products in the country, the latter was the preserve of the government which set prices in consultation with the oil marketers; this was left entirely to supply and demand mechanisms of the market.

Before deregulation eight oil companies heavily dominated the domestic downstream petroleum market ranging from procurement, refining, storage to transportation and retailing. By 1996 these companies controlled 100% of the retail market with a retail network of about 700 (Mecheo & Omiti, 2003). Regrettably, given the significant entry

barriers to Kenya's oil industry, few independent dealers have managed to enter the industry and have a combined market share of about 10% following liberalization. In addition, only a few of the new entrants manage to import refined or crude oil for processing at KPRL and engage in product distribution. The majority purchase crude oil and refined products at a high premium from the already established oil marketers for reselling; this has effectively limited their impact in the oil market in terms of competition.

The Kenyan oil market still retains the oligopolistic structures in the liberalization period just as it was during the era of price controls. The new entrants have not made a definitive impact due to the inherent structural barriers. These include the capital intensive nature of investments in the petroleum sector as it costs between 20-50 million shillings and about 5 million to set up a petrol station in urban and rural areas respectively. There is also the lack of /inadequate petroleum truck loading facilities in the major market zones and hindrance by the established marketers to offer "hospitality" to the new entrants. However, to address the problem the government has constructed and commissioned common user truck loading facilities in Nairobi (NOCK) and Western Kenya (KPC). The base load processing requirement that new entrants start immediately on being licensed to process at least 500 metric tons of crude oil every quarter at the KPRL. The requirement that all companies using the pipeline retain 2,400 cubic meters of products as line fill in the pipeline system of the first year of operation of 4% of a company's sales. Lack of LPG filling infrastructure therefore leaves the entire LPG market to established marketers.

Besides the above impediments, other factors such as the Iraqi war and the continued efforts by the United States government's war on terror have contributed to oil pricing

volatility. Crude oil prices rose steadily from $25 to $30 per barrel in 2003 before touching an all time high of $55 per barrel in October 2004. Prices have declined marginally since but there is still no clear indication as to where it may settle.

These factors have minimized the positive impact on prices by the new entrants. The expectation that liberalization in oil industry would not only ensure sufficient supply but would also intensify competition and thus competitive price is yet to become a reality. A report entitled "status of Petroleum sub sector in Kenya" Nairobi Institute of economic Affairs (NIE) 2000, observes that the major marketers still continue to wield considerable market power. Although liberalization saw the entry of other foreign and local players into the industry, the circumstances in the sector point to the fact that it is unlikely that the market has become less concentrated. For instance the new players rely on the major marketers as suppliers for their retail outlets hence their overall competitive effect is minimal.

As the government liberalized the petroleum sector in the face of donor pressure and domestic demands, it overlooked fundamental concerns that would have seen the exercise succeed. Even before liberalization the petroleum market was uncompetitive but the government moderated the adverse effects of such through intervention. It has been observed that a situation where the market is not competitive, privatization transforms public monopoly into private monopoly. In the absence of an effective and appropriate regulatory structure the private monopoly has negative effects where benefits are privatized while imposing costs on society (Boubakri & Cosset 2002). This is what probably has happened in the oil industry in Kenya since liberalization.

Besides, the influence the government has on the levels of petroleum prices through fiscal policies currently is limited to price monitoring. The government monitors supply, distribution and marketing environment with the view of providing information on retail pricing by different companies to the consumers through the mass media. This way, the cartel-like activities and artificially created shortages of petroleum products have been curtailed and check on distortion of consumer prices (GoK, MoE report 1995/96). The effect and efficiency of this policy remain to be felt, given the oligopolistic nature of the petroleum market. The government needs a more efficient regulatory instrument to ensure prices are determined by petroleum market forces; there is need for more power for intervention than prevails. Not even the Restrictive Trade Practices, Monopolies and Price Control Act, chapter 504 of the laws of Kenya that vests the government with authority to encourage competition in the entire economy by prohibiting restrictive trade prices, has been useful.

The failure of this Act to provide the government with rapid, effective interventionist's powers has been demonstrated in numerous situations in which the government remained powerless to act when the oil firms increased petroleum product prices. For instance in 1996 the government had warned the oil firms against increasing prices as this was believed to be speculative. The oil firms maintained that the prices of crude oil in the international market had increased and they had to increase consumer prices in order to generate additional funds to enable them import crude oil and refined products. The firms went ahead and increased petroleum product prices the government's concern not withstanding (East African Standard, Business &Finance, 1996).

Despite the factors behind the price increase the firms had adopted an oligopolistic type of price leadership in adjusting their prices resulting in hikes even for prices of products

of the smaller companies which were not affected by the alleged supply cost hikes (Oketch & Nyoike 1999). According to an article in the East African standard (April 1996), the consumer prices of petroleum have remained a bone of contention between the oil companies and the government since the sector was deregulated. The situation has not changed (and unlikely to) unless the government establishes an effective and appropriate intervention framework.

2.4 CONCLUSION

The hope that a genuinely competitive pricing regime would emerge from liberalization and deregulation remains unachieved. For liberalization and deregulation to succeed they need to be accompanied by an appropriate regulatory framework and mechanisms to ensure as far as possible that market competition operates among the principal marketing and retailing companies. In the absence of such legal framework and the institutional capacity and readiness to enforce it, oligopolistic practices and price leadership are likely to prevail at considerable cost to the economy and the consumer (Oketch & Nyoike 1999).

There is a negative correlation between the increasing price of petroleum products and Gross Domestic Product growth rate. The rise in prices of petroleum product, which is a major source of commercial energy for the modern economy, means increase in prices of various products and hence increase in inflation rate (Mecheo & Omiti, 2003). This is an indication that there are limited benefits to consumers which is a contradiction of the one of the justifications for liberalization that envisaged that consumer welfare would be enhanced as a result of competitive prices determined by the market.

From a political economy perspective there, is an overriding need to create economic space in which states can and must play active roles in guiding economies so that they are responsive to particular social, cultural and political circumstances (Bienfield, 1994). The case for state intervention to promote industry and technological development is strongest when there are large potential learning externalities, high barriers to entry and strong reasons to attaching importance to a society's eventual ability to generate and appropriate significant technology rents. The free market ideology is not without a down side and it has been demonstrated in the oil industry in Kenya and what needs to be put in place is a well balanced policy between efficiency and fairness.

The biggest gain derived from trade liberalization in the oil industry has been reliability. Fuel shortage which was common in the days of control is no longer experienced since the government no longer has direct influence on prices. Free market forces and price leadership associated with oligopolistic pricing behavior seems to have been adopted by the oil industry sub-sector in Kenya as a mode of pricing mechanism.

CHAPTER 3:

TRADE LIBERALIZATION IN KENYA: A GENERAL OVERVIEW

3.1 INTRODUCTION

This chapter focuses on the phenomenon of trade liberalization and most fundamental, the impact it has had on Kenya's petroleum sector since 1994. In this chapter, we shall examine the justification and the structures put in place to ensure fair play in the industry. This chapter also explores the performance under liberalization, the gains and challenges and whether the expectations have been met.

3.2 The Government Structures in line with the Liberalization

At independence in the early 1960s many countries in Sub-Saharan Africa built up highly interventionist and protectionist trade regimes. These regimes were broadly characterized by: First, on the import side by restrictive licensing systems, high tariffs, escalated tariff structures made up of several layers, varying degrees of import prohibitions, and tight foreign exchange controls. Second, on the export side the trade regimes were marked by substantial implicit and explicit taxes as well as frequent use of non-tariff barriers such as prohibition of certain export items (Oyejide1997).

These trends that characterized the pre-liberalization trade regimes were traceable to the desire to protect domestic industries in the context of Import Substitution Industrialization (ISI) strategy that was in vogue in Sub-Saharan Africa during the 1960s and 1970s. This was evident in extensive exemptions from tariff rates on imported inputs used by local producers. During this period trade regimes of many SSA

Countries exhibited a strong relationship between the use of import restrictions and the appearance of balance of payments problems. Balance of payments concerns, together with budgetary needs had probably much stronger impact on the evolution and structure of pre liberalization trade regimes in countries that had desire to protect local manufacturing concerns (Oyejide1997).

However, beginning in the early 1980s the African political and economic landscapes were clearly undergoing remarkable change. On the economic front, various policy reforms addressed issues of macro economic stabilization and structural adjustment, which included unilateral trade and financial liberalization, privatization, deregulation, and investment facilitation.

Economic liberalization comprising trade liberalization was the mantra of Structural Adjustment Programmes (SAPs) that intended to revamp the stagnating national economies through efficient resource allocation. According to an article in Review of Political Economy, No.80,1999), the argument was that successful national economic development was possible only in so far as it conformed to the logic and determination of global markets. This conformity was disseminated and supervised by the international financial institutions that included the deregulation of markets and the privatization of state owned enterprises, the scaling down banks involvement with the government and the liberalization of trade. These undertakings were seen as desirable policy initiatives that would engender efficiency and increase welfare.

The World Bank argued that trade liberalization would help eliminate distortions between international and local prices to create a favourable environment for better

economic performance. It would therefore influence GDP growth, trade balance, and budgetary equilibrium through its impact on fiscal revenue (Bamou, 1999).

It is within this context that many developing countries (Kenya included) deregulated their petroleum sectors as a critical component of their macro-economic liberalization policies. Kenya liberalized its petroleum industry in October 1994. The government noted that the prevailing environment favoured the policy shift i.e. the existing oil marketing companies at the time could offer moderate competition, the country's oil infrastructure was flexible to handle imports of both crude oil and refined products.

However, the liberalization of Kenya's petroleum industry has not met the desired objectives i.e. improving operational efficiency, attracting private capital into the industry, and enhanced consumer welfare through increased competition.

3.3 Justification of Trade Liberalization

The push for trade liberalization was carried out against certain broad expectations that contended it could spur sustained economic growth for the developing countries. SSA countries attained independence during the time of welfare state orthodoxy and virtually all governments intervened in the economy in a number of ways. The African countries had become dependent on heavy bilateral and multilateral borrowing from the West in order to meet the demands of the welfare state system. This heavy borrowing was beneficial to the Western financial markets and financial investors as long as repayment was on schedule (Chweya, 2004). However, many developing countries failed in their repayments sparking a debt crisis in the late 1970s compounding the economic crisis in the West.

Part of the solution to the crisis lay in internal economic adjustments in African countries in order to raise their capacity to service external debt and overcome the debt crisis. Chweya, 2004), states that the modifications to the African welfare state entailed among others deregulating and liberalizing the economy in order to give way to the free market system that would spur economic growth through export oriented private sector-initiated production, and secure a balanced budget with surplus for debt repayment. Western governments prodded the African countries to introduce these changes in their economies through the World Bank sponsored SAPs beginning the early 1980s but dominant in the 1990s because of a changed global system. Unlike the 1980s, in the 1990s the neoliberal agenda was more aggressively imposed by a hegemonic power that had little need to compromise in the absence of a rival hegemonic power or widely accepted ideology (Bienfield, 1994).

It was argued that trade liberalization could provide expanded market opportunities when coupled with reduced discrimination against exports, these could enable more exploitation in exports, and this could therefore allow exploitation of comparative advantage, permit greater capacity utilization and enhance exploitation of economies of scale.

By reducing anti export bias trade liberalization stimulates export performance particularly non traditional exports. Trade liberalization could increase competition from abroad and enhance access to better technology leading to innovations and higher productivity (Oyejide, 1997).

In a properly managed structure, trade liberalization produces an outward oriented trade regime that confers certain productivity enhancing and growth promoting features on the liberalized economy. The most notable among these are improvement in efficiency with which resources are allocated, increase in competition and product specialization, enhanced ability of the economy to attract foreign investments, and creation of a favourable environment for technology transfer

3.4 Trade Liberalization: The Expectations

The process of trade liberalization has been attributed to either unilateral moves by the individual states or multilateral initiatives by the international finance institutions. The multilateral drive resulted from conditions imposed on the liberalizing countries for gaining access to external financing in exchange for policy reform in the context of Structural Adjustment Programmes (SAPs). In some countries they undertook some unilateral trade liberalization efforts that were associated with positive external shocks that enabled these countries to finance their liberalization attempts.

The SAPs shaped the design, scope, and sequence of trade liberalization processes in many African countries (Kenya included) since the mid 1980s. In terms of scope, trade liberalization process covered tariffs and non tariff measures such as quantitative restrictions and exchange control. In Kenya for instance the National Oil Corporation of Kenya was allocated 30% of the crude oil imports into the country but following deregulation this quota was abolished.

The process of reducing quantitative restrictions was reinforced along by the elimination or relaxation of foreign exchange controls in virtually all countries in SSA. In fact, the

relaxation of foreign exchange controls saw a decline in the parallel market for foreign exchange. The neo-liberal policy prescription has been viewed as having serious consequences for most parts of the developing world.

Indeed in some countries, they have reversed the trend toward trade liberalization. This was triggered by balance of payments and fiscal incompatibility. The reluctance on the part of governments to refrain from using traditional trade policy instruments for addressing incompatibility issues made policy reversals inevitable (Oyejide1997).

3.5 Performance under Trade Liberalization

To gauge economic performance under trade liberalization one has to look at changes in output, various components of trade, and performance in the manufacturing sector. Under trade liberalization, there was a shift of resource away from import substituting and non-tradable sectors to the tradable. This has led to increase in exports in some countries.

In some countries however, a certain degree of industrialization took place. Trade liberalization unleashed competitive pressure that many previously sheltered and inefficient industrial firms have been unable to cope with and new export oriented activities have not bloomed sufficiently to take up the slack.

The credibility of many trade liberalization episodes has been suspect. Indeed their aid nature and their inherent compatibility with basic economic reality in the absence of assured long term external financing has led to ineffectiveness.

The context under which trade liberalization programmes are implemented has profound implications for their sustainability and success. Most of the recent trade liberalization drives in SSA were characterized by unilateral attempts that focused primarily on imports, were designed and implemented as integral parts of SAPs reform packages, and were aided by external financing.

3.6 Liberalization of the Oil Sub-sector in Kenya:

(a) The Gains and Challenges

The economies of African countries have traditionally been influenced by development in the world economy as these are mediated through changes in commodity prices, in the prices of African imports, flows of foreign assistance and direct foreign investment. As the global economy started to open and scaling back the role of government. Kenya was no exception to these worldwide changes.

In October 1994, the government substantially reduced its role in the petroleum sector. Since then, the challenge has been how (especially for non producing countries like Kenya) to best manage the deregulation, liberalization, and expansion of petroleum and retailing in the best interest of the population.

The liberalization in the petroleum sector entailed, freeing of procurement, distribution, and pricing of petroleum products in the country. Whereas in the past the government in consultation with the oil marketers set consumer prices, in the post-deregulation period this responsibility is in the hands of the market'. Exchange rate, cost of crude oil and products, and product margins based on import disparities of products have been the key parameters in setting consumer prices in the post 1994 period. However, price

and profit margin setting mechanism have remained more or less the same as they were under the controlled markets, although the significance of some parameters has changed in conformity with liberalized market conditions.

The current pricing structure of petroleum products in Kenya at the retail market level has not been influenced by the price deregulation effected by the government in October 1994. In fact, the petroleum product pricing principles have not been influenced by the deregulation at the retail pump level, and the realignment of product prices to correlate with international prices only facilitated an increase in gross profit margins of oil companies (Oketch & Nyoike, 1999). Indeed there were no reductions in consumer prices arising from these measures. The expected welfare gain for the consumer resulting from competitive pricing has not taken place. It can be safely argued that deregulation in an imperfect market leads to limited potential welfare gains.

Deregulation of the petroleum sector in 1994 led to the abolition of the white oil rule. This provision required the oil marketers by dint of their individual agreement to process crude oil at KPRL in order to meet the national demand for refined petroleum products. With the abandonment of the white oil rule the oil marketing and distribution companies were allowed to import refined petroleum products excess of their base load contribution for processing at KPRL. Every marketer imported crude oil proportionate to his share of LPG contribution in the local market. The national requirement of crude oil required to produce adequate LPG for the country was estimated to be approximately 1.6 million tones (PIEA Publ, July-Sept, 2005). As a result, there was a reduction in importation of crude oil while importation of refined products increased.

The liberalization of the petroleum sector saw a reduced role for National Oil Corporation of Kenya (NOCK). It was mandatory for NOCK to furnish up 30% of the country's crude oil requirements; this was meant to ensure reliability in supply and stability in prices in the country. The justification for NOCK'S creation was that given the strategic and sensitive nature of the oil industry it would be improper to leave oil trading entirely in the hands of the private sector dominated by the multinationals. Upon the abolition of the quota, NOCK has since been reduced to an insignificant player in the oil industry. In addition, NOCK has been dogged by mismanagement despite its access to petroleum development levy provided by the government to develop retail infrastructure for use by independent oil dealers. The reduced role of NOCK meant increased market power for the dominant players in the petroleum sector that have effectively exploited their power by consistent price increases ("Price Increases not based on market costs" Daily Nation Article, August, 2006).

The government's role has largely been limited to regulation. Through the ministry of Energy the government has legalized minimum operational stocks of petroleum products. As earlier stated (in chap. 2), under the Essential Supplies, Imports and Exports Acts of the Laws of Kenya, the government requires the oil companies individually to stock minimum operational stocks for each product equivalent to 30 days consumption and 10 days for LPG. The Ministry of Energy ensures orderly supply of oil to Kenya through a tender committee whose membership includes the current oil marketing companies and Nock.

Liberalization facilitated the entry of new companies to trade in oil along the established oil marketing companies but currently there are over 110 licensed oil operators in the country which own or operate wholesale and retail facilities, (Daily Nation, business

week, Aug. 2003), of these 19 are registered as product importers. Neo-liberalism posits that deregulated, competitive markets will tend toward a stable full employment equilibrium which maximizes welfare. It foresees a scenario of a self-regulating economy guided by market forces with little or need for explicit policy choices regarding a society's long term priorities.

The expectation was that deregulation would allow entry of more oil marketers and intensify competition with consumers benefiting from competitive and fair prices. This has not taken place because deregulation on its own did not sufficiently eliminate the institutional and structural barriers to oil trading in the country.

As demonstrated by the table below, the study shows that 10 years after liberalization, the multinationals share dropped to 74%, NOCK captured 6% while the Independent Dealers combined got about 20%. The study reveals that though their has been high expectations that NOCK with the intervention of government which has provided infrastructure would steer the competition against the established oil marketers, its growth has been slow and has not posed much challenge.

Table 3. 1: Shipper's Product Share Cubic Metre (Cu. M) 2004/05

<table>
<tr><th>Shipper</th><th>Volumes (m^1)</th><th>% share</th><th>% share</th></tr>
<tr><td>SHELL</td><td>580,750</td><td>17.5</td><td rowspan="6">74.3</td></tr>
<tr><td>TOTAL</td><td>563,705</td><td>17.0</td></tr>
<tr><td>CALTEX</td><td>487.451</td><td>14.7</td></tr>
<tr><td>KOBIL</td><td>486.815</td><td>14.7</td></tr>
<tr><td>MOBIL</td><td>348,284</td><td>10.5</td></tr>
<tr><td>KENOL</td><td>425</td><td>0.01</td></tr>
<tr><td>NOCK</td><td>197,923</td><td>6 0</td><td>6.0</td></tr>
<tr><td>PETRO</td><td>120,200</td><td>3.6</td><td rowspan="3">19.8</td></tr>
<tr><td>HASS</td><td>106.909</td><td>3.2</td></tr>
<tr><td>METRO</td><td>80,954</td><td>2.4</td></tr>
</table>

HASHI	72.339	2.2	
TRITON	69,597	2.1	
DALBIT	67,899	2.0	
GALANA	42,795	1.3	
FUELEX	31,854	1.0	
MOIL	31,062	0.9	
SOMKEN	25,021	0.8	
MAFUTA	2,407	0.1	
GAPCO	2,158	0.1	
ENGEN	1.840	0.1	
JOVENNA	1,759	0.1	
Total	3,322,148	100	100

Source: KPC Statistics Bulletin 2003/04 -

****Share is based on pumpovers and not on the National figures. However, what KPC handles is a fair representation of the Shipper market share.**

2006

Table 3. 2: Shipper's Product Share Cubic Metre (Cu. M) 2006/07

Shipper	Volumes (m')	% share	% share
SHELL	705.988	18.5	69.4
KOBIL	563.572	14.7	
TOTAL	553,680	14.5	
CHEVRON	487,820	12.7	
MOBIL	344,009	9.0	
NOCK	162.886	4.3	4.3
PETRO	133.455	3.5	26.4
HASHI	118.529	3.1	
HASS	100,494	2.6	
FOSSIL	100,347	2.6	
GALANA	94.530	2.5	
DALBIT	85.405	2.2	
OILCOM	54,795	1.4	
GAPCO	46.630	1.2	
BAKRI	45.921	1.2	
METRO	45,389	1.2	
MOIL	44.126	1.2	
TRITON	43.727	I.I	
GULF	34.471	0.9	
ADDAX	22.039	0.6	
MOGAS	18.560	0.5	
MGS	12.973	0.3	

Shipper	Volumes (m*)	% share	% share
ENGEN	5,591	0.1	
EMPEX	1.226	0.0	
Total	3.826,161	100.0	100

Source: KPC Statistics Bulletin 21305 / 06 -

***In 2006, as the table indicates, multinational share dropped further to 69.4% as the Independent Petroleum Dealers increased. This scenario indicates that though at a slow pace, with the right support and various government interventions, the IPDs market share will improve and will bring about competition in the sub-sector.**

The new entrants into the oil industry have to contend with heavy capital and infrastructural investment, storage and loading facilities usually in the hands of established oil marketers. Indeed the domestic oil market has characteristics that foster the rise and sustenance of cartel like behaviour. A scenario that can be referred as 'cooperative oligopoly' whereby firms agree among themselves to jointly fix prices or production levels in order to maximize profits over the entire sector. The optimal strategy is for these firms to set the market price at the level which would prevail under monopoly and then distribute the resulting profits proportionally among themselves (Dostie et al, 1996).

In a situation like this (imperfect market) deregulation may lead to limited or no welfare gains. Indeed the bigger firms have an advantage over smaller ones through lower costs so that the market tends to be dominated by a small number of large firms.

In Kenya the oil MNCs dominate the petroleum sector since they are capable of importing large quantities of oil than the Independent Petroleum Dealers (IPDs) cannot. The majority of IDPs purchase crude oil and refined products at a high premium from the established oil marketers (Shell BP, Total, Mobil, Caltex) for reselling. Hence the overall competitive effect has been quite minimal.

It is argued that the oil market is not more competitive than it was prior to deregulation. The entry and smooth operation of new firms has been effectively frustrated by the traditional oil marketers and this has hindered the rise of competitive pricing mechanism. The established marketers wield considerable market power evident in their collective action in respect to new entrants defying directives from the Ministry of Energy (MoE). Even at the international level the oil market is dominated by a few players who readily cooperate against any aggressive competition. An investigative report by the office of Commission of Monopolies and restrictive Practices indicates that the oil market in Kenya is far from perfect, the IPDs control a market share of 15% not huge enough to threaten the established marketers.

The partial scaling back of the government's role in the oil sector left a vacuum that has been exploited by the players in the industry. Despite the existence of a legal and regulatory framework, it is not sufficient to discourage malpractices such as oligopolistic collusion. The sector was liberalized in 1994 without a comprehensive energy policy and petroleum bill, this lack of an effective regulatory framework to guide the operations of a free market has defeated the stated purpose of deregulation.

The Restrictive Trade Practices, Monopolies and Price Control Act (cap 504, Laws of Kenya) mandates the government to encourage and foster competitive market behaviour and discourage restrictive trading arrangement (Mecheo & Omiti, 2003). However, this provision has not been sufficient to discourage uncompetitive practices in the oil industry. The government requires a more effective and efficient legal and regulatory framework to ensure that prices are determined by the market forces, given the oligopolistic nature of the oil market. The existing law is ineffective in two ways. First, an offence is deemed to have been committed when there is an arrangement

between the sellers to influence the prices. Implying pricing mechanisms based on convert behaviour and inherent market failures are not satisfactorily catered for in this legislation. Research indicates an oligopolistic structure in the oil industry has a cartel like market behaviour in determining petroleum product prices since the advent of market deregulation. The mode of pricing employed is leadership, as noted in chapter one does not require any explicit arrangement among the various players in fixing petroleum prices (Dostie et al, 1996, Mecheo & Omiti, 2003).

The advocates of the strategic trade theory argue that in the face of market imperfections and distortions such as monopolistic and oligolipolistic practices, the state can objectively intervene in the economy to maximize national welfare. This is hardly a new phenomenon as even the much taunted 'Asian Tigers' such as South Korea have never implemented a neoliberal structural adjustment programme. Its economic liberalization has been selective and firmly grounded on a strong nationalist and interventionist policy framework (Bienfield, 1995). It is the contention of this study that the government should play a significant role to ensure effective intervention in case of market failure.

Secondly, the nature of penalties and the process of identification of an offence, prosecution and conviction are difficult to implement. The law stipulates that if an arrangement to fix prices is proved to exist the offenders are liable to pay a fine of Ksh. 100,000 or serve a jail term of two years in prison. The stipulated fine is negligible and cannot deter malpractices for oil majors with capital bases running into billions of shillings. In fact the petroleum Bill 2000 (now renamed as energy Bill) was meant to force the oil marketers to adhere to the tenets of a free market system. The Bill called for the formation of the oil industry Regulatory Board, and a Commissioner of petroleum

with powers to regulate decisions made by the oil industry. The Bill intended to see enactment laws that cover petroleum activities such as refining, transportation, licensing, environmental and safety standards. In the same year Shell BP bought out Agip, Total united with ELF reinforcing the oligopolistic structure and consolidating their control in the market.

3.7 CONCLUSION

The impact of deregulation in the oil industry has not been significant to the economy. The opening up of the oil industry saw the entry of new players but unfortunately, their impact has been minimal as they constitute less than 15% of the total market share. The petroleum product prices continue to be shaped by other factors other than international crude oil price.

The structural mechanisms have not been affected by the deregulation in the oil industry since October 1994. The petroleum product pricing principles have not been influenced by the deregulation especially at the retail level, and the insistence by the oil marketers to realign the product prices to correlate with international prices only helped to increase the profits for the oil companies.

Having noted the shortcomings witnessed in this industry, it is important that as the government undertakes to implements the reform programme, it must not be taken as an undertaking in which only prices are liberalized. The liberalization process should be pursued in tandem with infrastructural improvements and institutional change.

The Kenyan petroleum market still remains moderately concentrated and new market entrants face financial and non-financial barriers. Given the centrality of the oil industry to the performance of the economy there should be appropriate legal, regulatory and administrative frameworks in the event of market failures (this is quite common in some economic sectors like oil energy distribution that are natural monopolies, fields that require large capital outlays such that once a few players are in place they can manipulate prices and prevent entry of new players) in the oil industry especially with regard to failure by marketing companies to price their products fairly on the costs of genuine marketing costs.

This chapter presents the evidence for the two study hypotheses and state that government intervention where there is market failure is important to safeguard the consumers. Liberalization and possible actions/strategies Kenya can pursue to improve operational efficiency, and to enhance national welfare.

The long-term goal of energy development in Kenya is to achieve self-sufficiency in energy supply through an intensive energy generation programme that keeps in tandem with growth in demand. These require policies and strategies that must address the linkages between energy use and social welfare, poverty related issues of accessibility and affordability poverty related issues.

CHAPTER 4

A CRITICAL ANALYSIS OF THE RESEARCH FINDINGS OF THE STUDY

4.1 INTRODUCTION

In this chapter, a critical analysis of the study will be done to establish the findings of the study. The findings will give an indication of whether liberalization has spurred development or has made any impact in the oil sector in Kenya. At the conclusion of this chapter the study shall establish whether the entry of Independent Oil Dealers has made any significance in the industry or the whether the status quo has remained. The structural framework and infrastructure required to address issues arising from this industry have also been explored.

4.2 Trade Liberalization has spurred limited positive impact in the oil sector in Kenya

From the study it emerged that liberalization of the oil sector in Kenya has had a limited positive impact achieved against the reasons for its deregulation i.e. improve operational efficiency, attract private capital, and enhance consumer welfare. Under the context of a liberalized market, it was argued that resources would be allocated efficiently through market forces increasing competition and product specialization while enhancing the ability of the economy to attract foreign investment into this sector.

One of the biggest positive impacts of deregulation of the oil sector in Kenya has been reliability in supplies. The shortages of fuel that were common during the days of control have rarely been witnessed in the sector. This is positive to the economy given

that during shortages, prices tend to randomly increase with negative consequences to other sectors especially transportation and manufacturing.

Another positive aspect of deregulation of the oil sector is the increase in a number of licensed oil marketers. Initially there were seven oil marketers in Kenya but currently there are over 110 licensed oil companies in the country which own or operate wholesale and retail facilities, out of these 19 are product importers. For example Petro Oil Kenya Limited operates 24 service sections while in the past it was confined to transportation, it has by far the largest share of products processed of all of the new entrants at KPRL (PIE Publication, June 2005). Unfortunately the impact of the new entrants into the oil sector in terms of competition has been minimal given that they control less than 15% of market share.

However, the deregulation of the oil sector has largely engendered a negative impact on the overall economy. This study indicates (and others before) that an oligopolistic situation emerged in the oil marketing sector following liberalization. In the year 2000 Shell/BP bought out Agip, Total merged with Elf reinforcing the oligopolistic market structure instead of the industry witnessing intensified competition it has seen the operation of the oil multinationals consolidating their control in the market. This view was reinforced by an article entitled "The Urgent Need to Rein Kenya's Oil cartel" appearing in News Week publication of December 10-21, 2000 pg. 24.

In an interview with the Petroleum Institute of East Africa representative (Oil companies' representative body), says there exists no known pricing cartel in Kenya arguing that it is against the Kenyan regulations adding that a number of international oil marketers are strongly bound by Anti-Trust Laws of their countries of origin which prohibit joint

discussion on price setting or market sharing. This is hardly reassuring as there appear traits which indicate that there could be some MNCs[1], engaging in uncompetitive behaviour in the market, in disregard of anti-trust laws of their countries of origin.

Under such circumstances, Instead of benefiting from low or stable prices after deregulation, the consumers continue to pay more for petroleum and related fuel products. In 1996 fuel prices were up three times with the oil companies citing the increase of the price of crude oil in the international market. In one of these price hikes it was deemed to be speculative and the government had warned against the price increase but the oil companies collectively increased the prices in defiance of the Government warning (Weekly Review, October 1996).

In November 1997, the international cost of crude oil was 15 dollars a barrel, this was the lowest price in three years but this resulted to only a marginal reduction of one shilling by most of the companies. Then Permanent Secretary in the Ministry of Energy complained that the local oil companies were taking more than two months (ordinarily it should take only one month) to pass the benefit to consumers, when the price of

For example D.A. Yates "Central Africa: Oil and Franco-American Rivalry" in l'Afrique Politique 1998, observes the French Oil Conglomerate Elf has dominated petroleum development and marketing in Gabon, Cameroon and Congo-Brazzaville for a longtime. When Shell Oil Company (British firm) offered competition to Elf-Gabon the latter responded by integrating Shell operations with pre-existing Elf pipelines thus maintaining operational control over all oil production and marketing in Gabon. In Congo, Elf Congo gobbled up its non-French competitors in this case the Italian State Oil Company ENI -Agip. Today Elf Congo and Agip Researchers Congo work together in a joint-venture agreement; Elf takes 65% and Agip 35%. In Cameroon a local Elf subsidiary has virtual control of oil production and marketing.

Murbane Crude Oil (the type that Kenya imports) went down by 5.12 dollars a barrel (Economic review, Jan. 1998). Any changes in international crude oil prices is felt in the Kenyan market after about 30 days, which is normally the time it takes to exhaust existing stocks and replenish with new cheaper or costly stake (PIEA Publication, Sept-Dec. 2004).

The Government intended to foster competition but many of the new players did not survive because of the large financial outlays and also the terms and conditions in procurement and transportation requirement. The oil business (except for petrol stations) observes Ezraj Parker[2], is a game for "big boys" who have considerable know-how, credit lines and financial muscle. Indeed the Independent Petroleum Dealers have become dependent on the oil majors because majority cannot import huge quantities of oil products and also are unable to meet some of the obligations.

a) Importation of Petroleum Products

In order for a company to gain entry into the oil industry, the Ministry of Energy issues a free of charge license detailing the requirements. This allows oil marketing companies to import petroleum for sale in Kenya or to export to other countries.

The license is important as it enables a shipper to actively participate in processing of crude oil at the Kenya Petroleum Refineries Ltd. (Due to lack of import handling

[2] Ezraj Parker (Managing Director of African Gas and Oil Company Ltd, with more than four decades in oil industry two of them in Kenya) quoted during an interview in petroleum Insight, July-September 2005 (Nairobi: PIEA Publication).

facilities for LPG, KPRL is a key asset in ensuring security of supply of the commodity in the country and hence the requirement that all importers of petroleum products process crude oil).

However, a shipper has to meet the following conditions to qualify for the license:

i) One requires a processing agreement from Kenya Petroleum refineries limited,

ii) One requires a transport agreement from Kenya Pipeline Company.

iii) Currently one has to commit in writing that he will not require Ullage* (storage for the petroleum products) at Kipevu Oil Storage Facility (KOSF).

iv) One has to submit a letter from the company or companies willing to provide ullage/hospitality arrangement at Shimanzi Oil Terminal or Mbaraki.

v) One has to show proof of purchase 250 **MT** of crude coupled with physical transfer from seller to buyer.

vi) One requires a certificate of incorporation incase of a registered company in which case it should be.

vii) One has to adhere to the 70 percent importation rule. See (i) above.
viii) One requires a Lease agreement incase of rental premises.
ix) One requires a work permit incase he/she is a foreigner.

b) Wholesale of Petroleum Products

i) This allows oil companies to buy and sell petroleum products in bulk (resale).

ii) The licence is important as it serves as means of regulating this activity and vetting to ensure that only serious traders are issued with it.

iii) The licence is a free issue.

iv) The license is as in (ii) above.

Transportation and Storage Agreement

Receipt and storage of Petroleum Products at KOSF shall be in accordance with the KOSF Operating Procedures prepared in consultation with the marketing company (hereafter referred to as "Shipper"). In the event of conflict between the provisions of KOSF Operating Procedures and this Agreement, the provisions of this Agreement shall prevail.

Subject to the notification procedures under clause 9.3, all Petroleum Products received into KOSF shall be transported by KPC in-land, unless otherwise specified in writing by shipper to KPC at least two (2) days prior to the date of discharge of Petroleum Products at KOSF.

<u>Receipt and delivery conditions</u>

Receipt Conditions

Petroleum Products shall be made available at the Point of Entry at the following rates and pressures: -

	FLOW RATE	
	Initial	Ultimate
All Petroleum Products:	440m3/hr	870m3/hr

All such products shall be made available by the Shipper to KPC at the Point of Entry such that the absolute pressure of such Petroleum Products when measured at the datum level of 58.49 metres Limit within Operating Standard Terms (LWOST) under normal operating conditions shall not be less than three metres of head above vapour pressure at 30°C operating temperature.

i. At Kipevu Oil Terminal, all vessels discharging white oil products shall maintain a maximum backpressure of 12 bars at the ships manifold and a minimum acceptable flow rate of 700m3/hr.

ii. KPC shall issue weekly programmes to shipper of all vessels scheduled to discharge at Kipevu Oil Terminal (KOT) into KOSF indicating the date, range, name of the vessel, the grade and quantity of Petroleum Products to be discharged. A shipper shall be required to make known to KPC the name of the vessel at least 10 days before the scheduled arrival date. KPC shall not be held liable for Petroleum Products in excess of declared quantities or demurrage charges accruing thereon.

Delivery Conditions

iii. Deliveries from the System shall be governed by the following conditions:

iv. The shipper shall maintain sufficient Petroleum Product stocks globally, excluding stocks at KOSF, to meet its daily requirements. KPC shall suspend deliveries to the shipper with zero or negative entitlements.

v. KPC shall issue Daily Product Entitlement Reports, daily ASEs confirmations, a weekly Shipping Schedule and Weekly KOSF Nominations to a shipper.

vi. The minimum capacity of a truck or rail wagon shall not be less than 5m3. Part loading shall not be allowed at any Delivery Point.

vii. No single tank-to-tank delivery shall be less than 70m3 of any one grade unless the custody transfer is carried out by way of a meter reading.

viii. At Kipevu Oil Terminal all nominations for back loading of white oils shall not be less than 1000m3 of any one grade, loaded as one parcel.

Delivery to Shippers Facilities

KPC undertakes to supply and a shipper shall receive Petroleum Products into their facilities at the following rates and/or pressures.

Nairobi Depots

GRADE	FLOW RATE	
	Initial	Ultimate
Premium gasoline	164m^3/hr	492m^3/hr
Regular	98,, „	98,,
Illuminating kerosene	59,,	177,,
Aviation Turbine fuel (Jet A-I)	34,,	77„
Automotive Gas Oil (AGO)	185,,	555,,

West Kenya Depots

Loading rates for Nakuru, Eldoret and Kisumu will be an average of approximately 1500 litres per minute for each grade.

Kipevu Oil Terminal

Loading rate from KOSF shall be as agreed between ship/shore but not less than 700m3 per hour.

SCHEDULING PROCEDURES

KPC shall be responsible for determining Petroleum Product pumping sequences and cycle frequency. Each cycle will be established to utilise the tankage and terminal facilities to the best advantage and Batch sequences will be designed to meet the needs of a shipper and the operational requirements of the System.

Minimum Pipeline Volumes

Batches shall be in quantities of not less than the following:

i) Mombasa - Nairobi

12,000 m3 of Premium Motor Gasoline

3,000 m3 of Regular Motor Gasoline

9,000m3 of Dual purpose Kerosene

17,000 m3 of Automotive Gas Oil

12,000 m3 of Jet A-1 (Avtur)

ii) Nairobi-WKPE

10,000 m3 of Premium Motor Gasoline

1,800 m3 of Regular Motor Gasoline

4,500m3 of Illuminating Kerosene

10,000 m3 of Automotive Gas Oil

3,600 m3 JET A-1

The minimum Batch quantities may be varied from time to time by KPC in light of actual operating experience and fluctuations in Petroleum Product demand. Any such variations shall be notified to the shipper through the appropriate Notification as specified in Clause 9.3.6 below.

TARIFFS

For each standard cubic metre of Petroleum Product delivered at a Delivery Point in accordance with this Agreement a shipper shall pay KPC a tariff exclusive of all statutory charges and taxes. The tariffs applicable as at the date of this Agreement are as follows: -

Entry Point	Delivery Point		Tariffs	
			US$	KShs.
Mombasa	Nairobi Terminal		-	1,530
Mombasa	if ti	(Jet A-1)	21.15	-
Mombasa	JKIA	(Jet A-1)	21.15	-
Mombasa	Moi Airport	(Jet A-1)	21.15	-
Mombasa	Nakuru	(Local)	-	2,105
Mombasa	Nakuru	(Export)	33.50	
Mombasa	Eldoret	(Local)	-	2,706
Mombasa	Kisumu	(Local)	-	2,703
Mombasa	Eldoret	(Export)	40.0	-
Mombasa	Kisumu	(Export)	40.0	-

i. For each standard cubic metre of Petroleum Product received into KOSF and/handled at the request of the shipper, the shipper shall pay KPC a handling fee of the sum of US$3.00. The fee shall be charged upon delivery of the product out of KOSF into the mainline, to KPRL or to offshore at the rates ruling at the time of such delivery.

ii. For each standard cubic metre of Petroleum Products stored at KOSF in excess of thirty (30) days, the shipper shall pay KPC on a pro-rata basis for any greater

or lesser storage duration as follows: between 31 - 60 days a shipper shall pay KPC US $ 5; over 60 days a shipper shall pay KPC US$10. The levies stipulated above are in addition to any other KPC Charges.

iii. After the thirty (30) days mentioned in Clause 15.3 above KPC shall not accept any more products from a shipper until a shipper evacuates its stock.

iv. For each standard cubic meter of Petroleum products delivered at shipper's agreed destination KPC shall levy a charge of US$ 10 per month or any part thereof, in the event that a shipper fails to collect the product within 30 days from the actual delivery date (MoE, Excerpts-KPC and transport storage Agreement)[3].

One of the key factors for deregulation of the oil sector was to attract private capital into the sector. One area that was considered in dire need of private capital was the Liquefied Petroleum Gas handling and storage facilities at the Port of Mombasa. The existing LPG handling and storage facilities were grossly inadequate. The situation has not changed 10 years since deregulation, and the consequence has been that the consumers have continued to experience serious gas supply constraints. As a result, the demand is regulated through pricing which is inconsistent with government policy of fostering competition in the sector (KPC strategic plan, 2005/10, MoE ref. ME/CONF/7/1/15). In its 2004/2005 budget the government zero rated Value Added Tax (VAT) on LPG but this has not improved accessibility as the decrease in price was minimal.

[3] Some of the requirements both for importation and transportation have acted as a barrier to gain entry into the industry especially for the IPDs

The LPG supply and pricing situation when compared with other countries is exploitative due to the fact that it is a by-product. In Kenya LPG consumption has stood at around 40,000 tonnes per year despite a high population of 32 million, whereas Senegal with a population of 10 million consumes more than 120,000 tonnes annually, Mauritius with a population of 1 million has an annual consumption of 60,000 tonnes of LPG (PIEA Publication, 2004). It is notable that Kenya's economy is much bigger than that of Senegal; all parameters indicate that the oil industry in Kenya has not done enough to address the LPG supply constraints. This situation calls for government intervention when the invisible hand of the market fails.

To address the above concern, the government intends through public - private partnerships to construct import handling and storage facility in Mombasa as well as storage facilities in Nairobi, Sagana, Nakuru, Kisumu and Eldoret (KPC unpublished manual 2003). Africa Gas and Oil Limited also intend to construct in Mombasa a modern common user importation terminal for LPG. The lack of LPG handling infrastructure has meant the entire LPG market is in the hands of established marketers (shippers). To curtail the abuse of their market power, the government standardized LPG cylinders, gas regulators and valves to allow flexibility of usage.

The challenge Kenya faces with regard to the oil sector is how to manage the deregulation, and expansion of petroleum marketing in the best interests of the

population. Kenya relies heavily on petroleum as a source of commercial energy as shown below[4]:-

i.	Transport	-	60%
ii.	Manufacturing	-	16%
iii.	Commercial establishments	-	11%
iv.	Households (LPG), Kerosene lighting and cooking	-	9%
v.	Agriculture	-	4%

Higher oil prices necessitated by an imperfect market have put pressure on inflation. Road transport is a major factor in the distribution chain, and motor transport is the popular means of commuter transport hence higher oil prices increases the cost of living. Between January and August 2005 retail prices for petrol, diesel and kerosene went up by 17%, 20% and 23% respectively and it took a threat from the Minister for Energy to cancel oil licenses for the prices to temporarily stabilize.

The expectation that prices, profit margins and price setting mechanisms could change positively after deregulation to enhance a competitive market environment has not happened. Interviews with oil industry player NOCK indicated some companies set the prices a little higher to exploit their power in the market, a rise in international crude oil prices notwithstanding.

[4] B Oketch and P. Nyoike "Kenya's Petroleum sub-sector in Context" in M R. Bhagavan (ed) Petroleum Marketing in Africa: Issues in pricing, taxation and investment. (London: Zed Books Ltd. 1999) Pg. 4.

Evidence shows anticompetitive practices such as price fixing pricing by collusive oligopoly, predatory pricing and discrimination in supply affect the welfare of the consumer negatively. The presence of these causes injury to the Kenyan oil consumer. For example, price fixing results in higher prices which in turn reduces the ability of consumers to meet their needs. Predatory pricing and practices especially below - cost pricing by the shippers has limited or nearly eliminated actual and potential competition in the oil market which in turn has exposed the consumer to limited choice and anticompetitive pricing. Market domination through allocation by major shippers has reduced competition and choice leading to oligopoly pricing.

4.2 An effective Legal and Regulatory Framework Is Necessary to Deter Competitive Practices in the Oil Sector

As has earlier been mentioned, one vital issue that was not adequately addressed before deregulation of the oil sector was an effective legal and regulatory framework in the oil sector. The Government established the Petroleum Monitoring Unit (PMU) in the Ministry of Energy (MoE) to; monitor international crude oil prices and the impact on the domestic petroleum market, to ensure that the mandatory operational stocks in the country are maintained, to enforce health safety and environmental (HSE) standards, and act as a link between the oil industry and the government. However, it emerged from the study that PMU is overwhelmed by the mandate of regulating the oil industry in Kenya (Mecheo & Omiti, 2003).

There is need to design an appropriate legal and regulatory framework and mechanisms to guarantee that market competition prevails in the oil sector among the principal marketing and retailing companies. However the absence of this regulatory

framework, institutional capacity and willingness to enforce it has led to the emergence of oligopolistic practices and price leadership in the oil sector. This has had a heavy cost to the economy and consumers.

The Kenya Government deregulated the oil industry and the oil companies set their own prices. Competition under girded up by market forces is supposed to determine price levels across the market, and it's the responsibility of the MoE to ensure competition exists. There has been failure in this regard by the MoE and a free pricing environment supported by free and fair competition is yet to emerge. Although the entry of new players into the oil market has introduced an element of competition in the market, as evidenced by varying prices across various towns in Kenya, this cannot be considered to be a fair parameter for competition (Boubari & Cosset, 2002).

An adequate regulatory framework is necessary to ensure fairness in competition by providing a level playing field for all market players. The players in the oil industry big and small are of the view that the regulatory mechanism is ineffective. The established oil marketers point out that ineffectiveness in regulations and standards enforcement has resulted in cheaper adulterated products getting into the market. The oil majors accuse the new entrants of malpractices i.e. adulteration and export diversion that have created market price imbalances especially in Western Kenya. On the other hand the new entrants accuse the oil major oligopolistic collusion to entrench themselves in the market. This is evident in the collective action the firms take in respect to new entrants.

For example there is the problem of below - cost pricing[5] that is practiced by the traditional oil marketers.

In order to counter this problem and to enhance competition in the oil sector, in 2003,the Ministry of Energy introduced a Single Entry Point (SEP) for all refined products in the country. The MoE directed that all oil imports be conducted through Open Tender System (OTS) on central tender presided over by the Ministry itself. Under this arrangement the product costs are virtually equalized for all marketers large and small. Any willing and capable oil marketer submits a tender to import and supply full cargoes of crude oil and products. The lowest bidder is awarded the tender to import all petroleum oil requirements for the rest to buy in accordance with market shares (Sunday Nation June 6, 2004).

This system was introduced to ensure bulk sourcing of refined oil at favourable prices and thus operating on the basis of similar oil importation costs into the country. This arrangement was envisaged to increase price homogeneity across the oil distribution and marketing sector in the country as it would cushion the small independent dealers who cannot afford to import full cargoes of oil individually. Though a cost effective method, the system has not benefited the IPDs who cannot afford to import full cargoes of oil and majority have opted to enter into "hospitality" agreement (at a fee) with the shippers for their supply and also to enable them lift their products.

[5] This is a practice whereby the established oil marketers sell their products below the procurement costs in areas where they are facing fierce competition from the new entrants effectively warding off competition because this is a kind of price war that the new entrants cannot afford.

This however, has not worked as anticipated since most of the independent dealers opt to distribute and not to import therefore leaving only a few established shippers to import. This need not be the case as the oil sector is too important to be left to a few private sector operatives, Kenya may not have direct control over the dynamics of international oil industry but it can benefit by streamlining NOCK operations and also empowering the few cost effective dealers to gain strength to offer serious competition to the big and established players.

The Restrictive Trade Practices, Monopolies and Price Control Act (GoK, 1989) entrusts the government with the mandate to foster competition in the economy. This law is deficient in ensuring competition in the oil sector for two reasons. First, an offence is deemed to have been committed if there is an explicit arrangement between sellers in the market to set/influence prices in the market. This legislation does not address covert behaviour and inherent market failures such as price leadership (which does not realize explicit arrangement among market players to fix prices) which exist in the oil market. Secondly the penalties[6], provided for in the Act are so low that they are unlikely to deter malpractices by companies like the ones engaging in oil business.

There is need for the government to provide stiff penalties that are likely to deter malpractices. For example companies that are engaged in collusion to fix prices can have their licenses cancelled or suspended and also impose heavy fines that will make uncompetitive behaviour a worthless venture.

[6] The Act stipulates a fine of KshslOO, 000/= or a two year jail term upon conviction. Even the smallest of the players in the oil industry can afford to pay this fine.

However one factor that probably inhibits the government from taking tough decisive action against the oil companies is the opposition from the multilateral agencies (the World Bank and IMF have pressured the government since 1991 to liberalize the energy sector) and bilateral donors such as US, Britain and Germany that have been pushing the neo-liberal agenda.[7]

The African governments are under pressure from multilateral donors and the G-7 countries to adopt neo-liberal policy strategies which discourage the active role of the state in the economy. However, evidence points out that state intervention and protection of the national economy is sometimes necessary despite emphasis about liberalization. The US, European Union and Japan have liberalized their markets and competition is a reality in their economies. But they do support large corporations or sectors in difficulty, (openly in US, subtly in Europe and Japan). They defy liberalism with subsidies[8], and monopolies for certain goods.

How deregulation is pursued in the oil sector has implications for the entire economy, the key objective is to avoid market failure. In the context of the oil sector in Kenya guided deregulation is preferable. This is a process in which the sector is moved gradually but steadily away from being state directed to being market directed. The process requires that all steps are carefully planned and substantially implemented, and

[7] This was evident during the enactment of the Donde Act in 2000. The Act intended to introduce interest rates controls among other measures charged by commercial banks; it elicited strong opposition from the World Bank local offices and bilateral donors arguing that interest rates should be market determined. This position eventually triumphed.

[8] Appropriate example is financial support from government sources for Boeing and Airbus aircraft manufacturers by the US and EU governments respectively. Airbus owned by Franco-German-Spanish aerospace firm EADS and Britain's BAE systems receives billions of dollars in loans and "launch aid" from EU States. Boeing supports from US government include federal contracts for military and space research, tax incentives in Washington State and benefit from tax arrangement the

that each step is consolidated before the next one is attempted that is enhancing the objective of building a truly market based sector. The idea of guided deregulation implies that first the government creates conditions that are necessary for the functioning of a truly market-run sector before embarking on deregulation.

The oil industry was deregulated before any institutional framework was enacted to guide the operations of the various players in the industry. The current Petroleum Act was last revised in 1972 and all along the government has been using legal notices to implement certain laws in the oil industry. Virtually all the players in the oil sector unanimously agree that the existing weak regulatory framework has hampered the realization of a competitive petroleum industry. During an interview with a PIEA representative, it comes out clearly that the oil sector was liberalized in 1994 without a comprehensive Energy Policy and Petroleum Bill to guide the industry in a free market. However the established oil marketers want the government confined to purely regulatory issues. NOCK also agrees that the oil industry needs a strong regulator to address and discourage uncompetitive practices prevailing in the oil Sub-sector.

The Government has had a Petroleum Bill in preparation since 2000 (renamed Energy Bill 2004) which has however not gone through Parliament. The Energy Bill 2004 seeks to create an Energy Regulatory Commission (ERC) to take over the oil industry regulation currently housed in the Ministry of Energy. The Energy Bill 2004 plans to repeal the Petroleum Act 1972 replacing it with the new Energy Act. The Bill caters for the following in the petroleum sub-sector.

World Trade Organization ruled as an illegal export subsidy". Financial Standard" The Standard 19

i. ERC will make regulations as necessary in areas of petroleum licensing, standards, design and construction, quality monitoring, environment, health safety, supply and strategic stocks.

ii. Operating licenses will be required for the following petroleum businesses; importation, refining, exportation, wholesale, retail, storage, parking and transportation.

iii. Construction permits will be required for pipeline, refinery, bulk storage facility, bulk LPG facilities, and retail dispensing sites.

iv. The Kenya Bureau of Standards is required as the agency for producing standards for petroleum products, equipment, facilities and installations.

v. Petroleum importers shall maintain stocks amounts as prescribed by ERC in consultation with the Minister.

vi. The Minister may with the consent of the National Assembly undertake the provision of whole or part of financing, procurement, maintenance and management of strategic stocks.

vii. The provisions of the Environmental Management and Coordination Act are fully provided for.

viii. For petroleum transportation; a petroleum transporter shall require a petroleum business license, a petroleum truck shall require a petroleum transportation permit, and a petroleum driver shall require a petroleum driver certification.

ix. That every local authority shall designate places for the parking of petroleum tankers (Ministry of Energy)

The current Bill is substantially altered from the original Bill proposed by Orwa Ojode (Member of Parliament, Ndhiwa Constituency) in the year 2000 with regard to fixing consumer prices which is probably the most important function that any proposed body can dispense. Instead, the current Bill covers mundane issues that are not central to economic growth, being a major source of commercial energy for the Kenyan economy, increase in prices of petroleum products has a ripple effect in prices of various products in the economy compounding inflation. Perhaps this should be the core function not an occasional oil Bill.

The Petroleum Bill sought to have an institution with powers to regulate decisions made by the oil industry, covering all petroleum activities such as refining, transportation, licensing, environmental and safety standards.

The petroleum monitoring unit itself acknowledges that the task of monitoring the oil industry is enormous. The Ministry of Energy monitors both domestic and international prices of oil urging oil companies not to increase consumer prices by margins not consistent with changes in crude oil price increases or depreciation of the Kenya shilling. The oil companies are required to effect price increases in consumer prices after depleting oil stocks bought at low prices. From the observations in the oil industry since October 1994 there is no time that the oil companies have heeded the Energy Ministry directive against unfair price hikes or unfair market practices. The PMU posits "the current Petroleum Act Chapter 116 makes it extremely difficult to deal with unscrupulous businessmen because the stipulated fines and penalties are extremely low."

CHAPTER 5:

SUMMARY, CONCLUSION, WAY FORWARD AND RECOMMENDATIONS

5.1 Summary and Conclusion:

The main objective of this study has been to investigate the impact of trade liberalization in the oil sector in Kenya since October 1994. Also the study set out to investigate the responses that the government has undertaken to ensure competition in the oil sector in order to protect consumers from market exploitation. This chapter highlights the importance findings that this study has revealed and suggests further research that should be done in this industry in a bid to formulate clear policies that can address the secrecy and problems in the oil sub-sector especially in developing countries like Kenya where oil contributes about 80% of the total commercial energy consumption and yet has no indigenous oil resources. And where effect of oil price rises sets in economic recession.

In chapter one, it was indicated that the oil sector was liberalized among others to improve operational efficiency, attract private capital and maximize national welfare through promotion of regional trade. However, as this study indicates, contrary to benefits envisaged, there has been limited positive impact due to institutional and structural barriers that have hindered the rise of a competitive market in the oil sector in Kenya.

Prior to the liberalization of the oil industry the government's level of participation was high, with less active private sector participation. The government's participation was

through Kenyan Petroleum Refineries Ltd, Kenya Pipeline Company, National Oil Co-operation of Kenya, and Kenya Railways Corporation. Marketing was exclusively in the hands of the private sector and the government in consultation with the oil marketers set consumer prices for petroleum products in the country.

On policy, this study recommends the strengthening of local Independent Petroleum Dealers (IPDs) participatory mechanism, cultivating on the improvement of the available human and capital resources and of course the governance. The Kenya government needs to put in place a strong regulatory mechanism to oversee the various sectors of the economy to ensure fairness among market players. The Kenyan oil sector needs a strong body to regulate the market operations, and deal with cases of market abuse.

5.2 Summary of the Study Findings:

The study has found that deregulation of the oil sector in Kenya has not benefited the consumers in terms of oil pricing and attracting effective competitors against the multinational companies as had been expected, however, supply of petroleum products has stabilized unlike the days of price controls. Deregulation has equally facilitated the entry of new players into the oil industry to offer a sort of competition to the established marketers in the oil industry.

A review of the expectations prior to deregulation reveals liberalization in the sub-sector has not yielded the benefits anticipated in a liberalized market. That prices and price setting mechanisms could bring a positive change after the deregulation has remained elusive. The domestic oil market has characteristics that foster the rise and sustenance

of a cartel like behaviour and the prevailing oil market is not necessarily more competitive than it was during price control regime.

The unstable price of oil has virtually increased the cost of living in Kenya. It was found that following deregulation; an oligopolistic situation emerged hindering the rise of a competitive oil market. The oil sector has not so far attracted much private capital into sub-sectors that were considered important. The consumer welfare has not been enhanced given the competitive practices such as price fixing by collusive oligopoly, predatory pricing, and discrimination in supply due to inadequate infrastructure. These have negatively affected the Kenyan oil consumer through high prices and limited choice leading-to exploitation.

This study has thus found that an ineffective and inadequate legal and regulatory framework has minimized the realization of gains derived from a competitive oil market and that the PMU set by the Ministry of Energy does not have the capacity to handle the mandate of regulating the oil industry. The lack of the regulatory framework, institutional capacity, policies to promote alternative sources of energy and political goodwill has denied the country the benefits of a liberalized oil sector to the economy and consumers.

To open up the sector for more investors, financing requirements should be relaxed to ease entry by individual or otherwise mutual assistance is encouraged in collateral and repayment. The government need not shy away from intervening in the oil sector; state intervention is a world wide economic phenomenon.

The study has established that the country over dependence on imported oil products is compromising to a growing economy since rise in oil results to severe setbacks resulting to slower rate of development in the country.

5.3 The Way Forward

The findings of the study indicate that contrary to pre-liberalization of the oil industry, liberalization of the oil sector in Kenya has yielded limited benefits. This is partly due to inadequate regulatory framework and also lack of punitive measures to discourage malpractices while promoting competition in the oil sub-sector.

The study proposes the following policy recommendations. Taking cognizance of the fact that the oil market as it is now represents potential case of market failure. This study proposes some policy recommendations (by no means exhaustive) to realize a competitive oil market and mitigate the negative effects of market failure.

5.3.1 Pursuing Alternative Sources of Energy

Kenya should actively promote alternative sources of energy such as solar, wind forms and natural gas. These will greatly reduce high dependency on oil as a source of commercial energy. Kenya should develop wind forms for the production of energy and effectively exploit solar energy.

Even within the international oil industry there is consensus that will be undoubtedly be a great expansion in the use of fuels other than oil. Natural gas piped or liquefied as LNG (Liquefied Natural Gas) is experiencing a great rise in demand in economic growth (Leong & Morgan, 1973). The government can promote and facilitate the use of

natural gas as an alternative source of energy by reserving land for receipt, storage and degasification plant of LNG which Kenya can obtain relatively cheap from the Arabia Gulf.

Kenya should explore ways of benefiting from the recent gas discoveries and production in Tanzania, as this may easily replace the expensive imported fuels used for thermal electricity generation. The communities and owners of large scale underutilized land should be encouraged to grow a certain spice of tree known as Jatropha that is used for bio-diesel extraction (Kefri, 2007).

5.3.2 Fuel-Saving Transport System

The rate of consumption of oil may be reduced by the development of better forms of transports which use less oil. The use of pipelines for transportation of oil, gas and refined products requires less fuel than conventional forms of transport such as tankers, trucks or locomotives. The government should invest in infrastructure as well as encourage private investors so that pipelines become much more common and may be considered to transport other commodities than oil. Others may include encouraging use of vehicles with improved fuel-consumption that can travel further with less consumption. The use of diesel rather than petrol is also economical and should be encouraged (Leong and Morgan, 1973).

5.3.3 Government Strategic Stocks

This should form part of an energy emergency plan for the country. For example Uganda has a strategic storage depot in Jinja with stocks owned by the government (PIEA Publ., July-Sept. 2005). A similar arrangement can be useful for Kenya to

ensure that the country is cushioned at times of marginal shortage in the world supply markets. This will have the effect of checking the consumer prices from unsustainable increases as the oil will be sold at the prices which it was procured.

5.3.4 Governments-to-Government Initiatives

The Government of Kenya should seek ways to benefit from oil in Southern Sudan. One proposal has been that Kenya should lead countries in the Great Lake region to pool resources to build a pipeline from Southern Sudan to the coastal town of Lamu in Kenya and from this vantage point, oil can be shipped to regional and world markets. It is worth noting that oil cargo freight cost is a prime consideration factor in setting retail prices for the petroleum products. Should the two governments implement this recommendation and given the proximity of Southern Sudan the cost of petroleum product will reduce considerably.

The Lamu port is favourable because the distance from Kapoeta to Mombasa is 1.020km compared with 4,500km to Port Sudan. These government initiatives are not new, Chinese and Malaysian governments have played key roles in ensuring their firms access Sudanese oil for use in their domestic economies (East African, April 2006).

Another example is Venezuela - Cuba cooperation, the Venezuela government supplies Cuba with oil at preferential rates and in return Cuba has over 17,000 social workers working in Venezuela paid by the Cuban government. The concessionary oil from Venezuela has enabled Cuba to experience steady economic growth from the down turn and stagnation it experienced in the 1990s after the collapse of the Soviet Union, which was a source of cheap oil for its economy (Considine, 2001).

5.3.5 Continued Oil Exploration

Many parts of the earth remain unexplored for oil, especially in remote areas where transport costs have been a deterrent. In Kenya, exploration spearheaded by KNOCK should be stepped up even beneath the ocean. Though this may pose problems due to cost of expertise and equipment, the government should attract strategic partners to enter into this venture.

5.3.6 An Effective Legal and Regulatory Framework for the Oil Sub-Sector

For the oil sub-sector to have been liberalized without a strong regulatory framework was a major omission. It is therefore imperative that an effective Legal and Regulatory Framework to guide the operations of the oil industry be structured. The country has had ample experience for the last 10 years since deregulation and has the capacity to put in place a strong regulatory framework to deter anti-competitive practices while enhancing integration in the oil industry.

The Restrictive Trade Practices, Monopolies and Price Control Act was meant to be a transitional piece of legislation as Kenya was moving from a price control regime to a market driven one. The optimal benefits of liberalization and deregulation are only realized when the resultant markets are competitive, some sectors of the economy might remain susceptible to noncompetitive behaviour or other market failures. This has been the case with the oil sector in Kenya. This will need to be addressed through some form of regulatory regime.

In the oil sector, regulation is necessary in order to contain and limit restrictive trade practices such as price leadership and abuse of market power through cartel pricing. A well designed regulatory framework will promote competitive utility management, attract private capital into the oil sector and promote cost recovery. The core role of the regulatory body is to counteract market failure; this is a widely accepted practice for sectors where competitive forces do not lead to optimal outcome.

Competition is an essential element in the efficient working of markets. It encourages enterprises, efficient working of markets and also choice. When the competitive process is itself frustrated intervention is justified. Indeed all the successful developed economies have vibrant competition authorities which oversee the market.

5.3.7 Government-led Development and Expansion of Infrastructure:

Inadequate infrastructure is one of the factors hampering realization of a competitive oil market. The government should play a leading role in the development of infrastructure especially in areas where capital outlay is huge; this could be either as a single entity or through public-private partnerships. The government's intention to construct LPG import handling and storage facility in Mombasa as well as storage facilities in Nairobi, Sagana, Nakuru, Kisumu and Eldoret should be fast tracked. Other capacity enhancement programmes such as construction of a parallel pipeline line as well as additional pump stations from Mombasa to Kisumu-Eldoret depots should be

actualized. The role of NOCK[9] in stabilizing domestic petroleum prices and secure public interest in such a vital industry should be enhanced through provision of resources. NOCK oil exploration as well as expansion of truck loading facilities should be stepped up to ensure adequate supply at all times.

5.4 Suggestion for Further Research and Recommendations:

The oil industry is dynamic and central to the functioning of the modern economy that no single study can conclusively come up with policy prescriptions. The existing policies appear to have stringent capital outlay and rigid requirements that make entry in the oil sector difficult and therefore creating a cartel like club for the players. However, this study has revealed that unlike pre-liberalized period when there were only 7 oil companies (multinationals) in the whole industry, there are now over 110 registered dealers.

The processes of liberalization and deregulation have been around for a while now and empirical evidence points out that remarkable progress has been achieved measured against the objectives for commencing the process. From the experience and knowledge gained in the deregulation, the government needs to intervene to ensure a competitive oil market emerges and cushion the economy from spiraling oil prices.

[9] Currently Nock has six service stations in the country which is insignificant. However Nock has the best oil exploration laboratory in the region offering internationally recognized petroleum exploration analytical data.

This study suggests that the government need to formulate policies that encourage aggressive pursuance of alternative sources of energy, provide adequate storage facilities to accommodate strategic stocks, government-to-government initiatives to secure cheaper sources of oil and initiate government-led development of infrastructure for the oil sector so that the IDPs can have options and avoid being too dependent on established shippers.

It further recommends that the government through the Ministry of Energy should have a reward/incentive system for individual or private entities that actively pursue and promote alternative sources of energy such as solar, wind farms and natural gas to reduce dependency on oil as a source of commercial energy. Towards this end, the government should strive to reserve sufficient funds for research related needs to develop alternative energy sources.

The study further recommends additional policy analytical work in the following areas: Energy conservation with a view of conserving oil consumption in our transportation systems and future petroleum infrastructure development and exploration.

Further research is required to address the emerging challenges in the industry and to help understand the potential market and opportunities available to cater for the short, medium and long term planning in the oil sub-sector development.

BIBLIOGRAPHY

Bhargaram M. R (ed) (1999). Petroleum Marketing in Africa: Issues in Pricing, Taxation and Investment. (London: Zed Books Ltd).

Barry. H (1978), "A case of Multinational oligopoly in Poor Countries: Oil Refinery Investment in East Africa" in Kaplinsky. R (Ed) **Readings on the Multinational Corporations in Kenya** Nairobi; Oxford University Press.

Considine, T. (2001), Oil stocks and the price response from stockpile sales: an econometric analysis, Department of Energy, Environment, and mineral economics Pennslyvannia State University.

Bennell P. (1996), Privatization in sub Saharan Africa: Prospects and Progress during the 1990s. London IDS.

Hardwick P. et al. (1994), An Introduction to Modern Economics (5n Ed) London: Longman.

Moore. P & Turner T 1980. Oil and Class Struggle London; Zed press Ltd,

Obi. C.I. 1997. Structural Adjustment, oil and Popular Struggles. Codesria Publication, Dakar.

Kegley C. & Wittkoff E„ (1993), World Politics and Transformation.(4ed), New York: st. Martins Press.

Nakanishi.T. & Komiyama.R (2006). Supply and Demand Analysis on Petroleum product and crude fuels for Asia and world, energy modeling centre, the Institute of Energy Economy in Japan.

Sengo. W.M et al (1980) Assessment of Commercial Energy Supply and Demand in Kenya. Nairobi Institute of Development studies.

Journals and Publications

Adepoju, Aderanti, (2000), Issues and Recent Trends in International Migration in Sub-Sahara Africa, International Social Science Journal Vol. 52)

Balabanis G., (2001). The Relationship between Diversification and Performance in Export Intermediary Firms, British Journal of Management, Blackwell Publishing.

Bamou, E. (1999), Trade Liberalization and Economic Performance of Cameroon and Gabon(Nairobi: AERC Research Paper,).

Bienfield M. (1994), "The New World order; Echoes of a New Imperialism^ in **Third World Quarterly Vol. 15 No.1 1994.**

Boubari. N and cosset. J.C 2002 "Does Privatisation meet the Expectations in Developing countries? A survey and some evidence from Africa" in **Journal of African Economies** Vol1. 11 Nairobi. Oxford University press.

Chweya A (2004), Emerging Dimensions of Security in the IGAD Region in M. Mwagiru (ed) African Regional Security in the Age of Globalization (Nairobi: Heinrich Boll Foundation)

Dostie B. et al. 1996, Market Structure and Trade Policy in Developing Countries: A general Equilibrium Approach. (Nairobi: AERC Special Paper No. 24).

GoK Publ, (2003), Economic Recovery strategy for Wealth and employment creation 2003-2007, Government of Kenya publication.

Ha - Joon Chang & Singh. A "Public Enterprises in Developing countries and Economic Efficiency" in **UNCTAD Review** No. 4, 1993.

Indetie L., 2003. Emergence of Independent Petroleum Dealers in Kenya. IPAR Special Report series.

Khor. M, January 2000 "Rethinking Liberalization and Shaping the WTO "A paper presented at World Economic Forum Davos 28 January 2000 in **Eco news Africa.**

Karekezi S, 1997 Petroleum and Investment in Africa: Policy Issues in the Downstream Sector. Nairobi: A FREPREN Working Paper No. 151.

Journal of African Economies Vol. 12 No.1 Nairobi; Oxford University Press 2003.

Kenya Pipeline Company 1993 & 1994. **Annual Reports and Financial Statements.**

Kisero. J 6 June 2004. "How price War at the oil depots hurts small man" in **Sunday Nation Market Journal.**

The Business and Finance Journal October 2000.

Mailu. T.K., 2003. Impact of Oil Import Dependency on a Developing Country: A Keynesian Econometric Model Analysis of the Kenyan Economy. (University of Nairobi, Unpublished M. A. Thesis).

Manyaga. C., 1998. Privatisation in Kenya (University of Strathclyde, Unpublished M.A. Thesis,).

Mecheo. J. and Omiti. J., 2003 Petroleum Market structure and pricing following Deregulation, IPAR Publication.

Mutitu C. N. and Nyoike P. M. **Structure of Petroleum Sector in Kenya.** Nairobi: AIREPREN Working Paper No. 19.

Ndikumana, L. September 2000. Towards a Solution to violence in Burundi: A case for Political and Economic Liberalisation" in **Journal of Modern African Studies.** Vol.38 No.3 London: Cambridge University Press.

Oyejide, A. 1997. Regional Integration and Trade Liberalization in Sub-Saharan Africa. Nairobi: AERC Special Report No. 28,.

Reinhart, C.M and Tokatlidis (2003), "Financial Liberalization: the African experience" **AERC supplement 2** vol. 12 October 2003.

Republic of Kenya, 1989. **Restrictive Trade Practices, Monopolies and Price**

Control Act (chapter 504) of the Laws of Kenya. Nairobi: Government Printer,.

Republic of Kenya, (2000), **Monopolies and Prices Commission:** Annual Report. Nairobi: Government Printers.

Republic of Kenya, (1995) **Kenya's Energy Sector Investment Programme** 1995/1996. Nairobi: Government Printers.

Shaw. R & Wamuyu (eds) 1998. Our problems our solutions: An Economic and Public Policy Agenda for Kenya. Institute of Economic Affairs,.

Schloss, M. 1992. "Does Downstream petroleum Trade Matter?" **Policies to Secure and Rationalize Oil Supplies in Sub-Saharan Africa.** Washington D.C. Industry and Energy Division Note No.14, World Bank,

Wagacha. M. 2000 Analysis of liberalization of the Trade and Exchange Regime in Kenya since 1980. IPAR Paper series, Nairobi.

World Bank, 2000: **Can Africa Claim the 21st Century.** Washington D.C: World Bank,.

Africa Analysis No .468 April 8th 2005

Daily Nation August 23, 2005, Nairobi.

Economic Survey 1995, Government of Kenya.

The Courier No. 164, July - August 1997, Brussels.

The Economic Review January 19-25, 1998

The East African April 3-6 2006, Nairobi.

The Standard April 19, 2005, Nairobi.

The Weekly Review November 11 1994

The Weekly Review October **18 1996.**

Newsline: December 11-21, 2000.

Petroleum Review Vol. 59 No. 703 London: Energy Institute, August 2005.

Petroleum Institute of East Africa: **Petroleum Insight.** September-December 2004. Nairobi: PIEA, 2004.

Petroleum Institute of East Africa, **Petroleum Insight,** January-March 2005. Nairobi: PIEA, 2005.

Petroleum Institute of East Africa, **Petroleum Insight,** April-June 2005. Nairobi: PIEA, 2005.

Petroleum Institute of East Africa, **Petroleum Insight,** July - September 2005. Nairobi: PIEA, 2005.

Report on status of petroleum sub sector in Kenya Institute of Economic Affairs, Nairobi 2000.

APPENDIX I

Key informants for the study included:

- Petroleum Institute of East Africa (PIEA)
- Ministry of Energy: Petroleum Monitoring Unit:
- Kenya Pipeline Company (KPC)
- National Oil Corporation of Kenya (NOCK)
- Retail Outlets
- Independent Petroleum Dealers Association
- Refineries
- Importers and traders

APPENDIX II

QUESTIONNAIRE:

The following questions that were uniform across the board were addressed.

1. To what extent has liberalization and deregulation of the oil sector since October 1994 engendered competition in the sector?
2. What have been the positive impacts of the deregulation of the oil sector with regard to improving operational efficiency, attracting private capital and maximizing national welfare?
3. What challenges does the Kenyan oil sector face in the post deregulation period?
4. What is the way forward for achieving the stated objectives of deregulation of the Kenya oil industry?
5. What are the effects of oil price rises in Kenya?
6. Which legislations need to be enacted to enable the consumers benefit from world market price reduction?
7. Having learnt from previous mistakes of commission and omission, in which ways can KPC and NOCK contribute towards creating a competitive market in the oil sub-sector?
8. Has the government effectively addressed the issue of over reliance on petroleum product and promotion of alternative sources of energy in Kenya?
9. In your view, do you think liberalization of the oil sub-sector has benefited the consumers in Kenya?
10. Has the entry of the local oil dealers in the industry assisted in the oil industry?
11. Which role can the government play to ensure competition in the oil industry?