SETTING THE AGENDA FOR THE DEVELOPMENT OF KENYA'S OIL AND GAS RESOURCES – THE PERSPECTIVES OF CIVIL SOCIETY

July 2014

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ACRONYMS

IOC	International Oil Company
IFI	International Financial Institutions
AOC	Africa Oil Corporation
KPR	Kenya Police Reserves
MEP	Ministry of Energy and Petroleum
CLO	Community Liaison Officer
MoU	Memorandum of Understanding
CRA	Commission for Revenue Allocation
CSR	Corporate Social Responsibility
NEMA	National Environmental Management Authority
EIA	Environmental Impact Assessment
NOC	National Oil Company
EI	Extractive Industries
NOCK	National Oil Company of Kenya
EITI	Extractive Industries Transparency Initiative
NRC	Natural Resource Charter
ERC	Energy Regulatory Commission
PSC	Production Sharing Contract
FPIC	Free, prior and informed consent
PWYP	Publish What You Pay
GDP	Gross Domestic Product
ESIA	Environmental and Social Impact Assessments
EU	European Union
ICC	International Criminal Court
IOC	International Oil Company
CNOOC	Chinese National Offshore Oil Company
EMCA	Environment Management and Coordination Act
KCSPOG	Kenya Civil Society Platform on Oil and Gas
MP	Member of Parliament
NEP	National Energy Policy
NUAC	National Upstream Advisory Committee
ODM	Orange Democratic Movement
RAP	Resettlement Action Plan
NAFFAC	National Fossil Fuels Advisory Committee
KNCHR	Kenya National Commission on Human Rights

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INTRODUCTION

Background

There is no doubt that the discovery of crude oil in commercial quantities creates significant potential for a country to transform its economy. For some countries oil has been a blessing, but for others, it has weakened state institutions, collapsed the traditional sectors of agriculture and manufacturing, caused violent conflicts and increased poverty levels. With the discovery of oil in 2012, Kenya is about to join the league of oil-producing countries.

However, what is not certain is whether Kenya will join the elite on the continent who have managed to use their natural resources to ensure inclusive and sustainable growth. The issues confronting resource rich countries are quite complex and require a systematic, comprehensive and inclusive approach in designing the frameworks that address those complex issues. The frameworks include the appropriate policies, legislation, regulations and institutions for the sector.

The development of these frameworks comes with its attendant problems particularly for frontier countries like Kenya with no previous experience in oil production. There is therefore a temptation to adopt frameworks from other countries despite the contextual differences between countries. The Government of Kenya has a responsibility to adopt frameworks that are consistent with the prevailing social, economic, political and cultural circumstances in the country so as to facilitate the development of the oil and gas industry.

As Kenya begins the journey of becoming an oil producing country, civil society organisations and citizens alike have expressed worry at the haste with which the country is developing its frameworks for the sector. There is also unease about the low level of public consultations, the potential for vested interest to be rooted in the frameworks, and the potential for oil to divide the people. Concerns have also been raised about the threat that oil poses to the environment, livelihoods of communities and security.

Figure 1: Map Showing Location of Oil Blocks in Kenya's Basins

Kenya Exploration Blocks

Source: National Oil corporation available at
http://nationaloil.co.ke/site/3.php?flag=upstream&id=2

As a result of these and many other reasons, the Kenya Civil Society Platform on Oil and Gas (KCSPOG) was established to mobilise civil society and citizens to play their rightful role of ensuring that the process for the development of the policy and legal frameworks is inclusive and participatory. That there is a need for effective engagement between civil society and the authorities to build consensus on major issues that will form the contents of such frameworks cannot be gainsaid. To facilitate this process, this report, "The Civil Society Agenda Setting Report" has been developed.

The report is intended to provide a common advocacy platform for civil society stakeholders in Kenya, as they articulate key demands to the national government and oil companies concerning the exploration, development and production of hydrocarbon reserves. A comprehensive overview of policies, legislation and institutions that are central to the industry's development, and to the wider evolution of the Kenya's economy and society, reveals priority areas that must be addressed.

The report addresses eight fundamental subjects:

i. Petroleum exploration and production

ii. Petroleum revenue management and distribution

iii. Local content

iv. Transparency and Accountability

v. Community and Environmental Rights

Generally, the report made significant findings.

a. Kenya is at its rudimentary stage of developing what will become an oil industry, which therefore requires the development of initial conditions around which the industry will be managed.

b. The governance regime for managing oil resources and revenues is inadequate in the light of existing and on-going progressive governance reforms being pursued by frontier countries like Kenya.

c. The existing policies and legal frameworks have important gaps relating to licensing, revenue sharing, institutional development and environmental sustainability.

d. The Government and its agencies have capacity challenges, which could affect the effective exploitation of the resources for the benefit of the people.

e. Citizens who are the primary owners of the resources are not aware of the benefits and dangers associated with oil development.

The report also proposes a number of measures that could address the challenges identified in the findings above.

This report was compiled independently by analysts who have canvassed the views of a number of informed individuals and institutions. These include stakeholders from government agencies, international oil companies (IOCs), civil society, and regulatory actors, legal institutions, community engagement specialists and private security agents.

Comparing Kenya with other emerging oil and gas industries, and drawing from lessons learnt in similar jurisdictions, this report analyses the Kenyan experience in comparison with international best practice, with the aim of helping stakeholders to benchmark policies and performance.

In the following sections, we present detailed analyses of the initial conditions in Kenya, the policy, legal and regulatory environment and the potential social and economic contributions of oil and gas in Kenya. Section 1 provides an overview of the oil and gas sector; Section 2 presents analysis of legal frameworks; Section 3 deals with the institutional framework; Section 4 deals with revenue management and distribution; Section 5 deals with local content; and Section 6 focuses on transparency and accountability. The other sections, 7 and 8 deal with Community and Environmental Rights; and key recommendations respectively.

Kenya: a political and economic overview

Kenya's economy is already well diversified, and a future government windfall from oil revenues could provide the opportunity to drive growth, and propel the country towards achieving goals set out in its developmental blueprint, Kenya Vision 2030. Commentators have argued that Kenya's divergent economy and relative stability shall ensure it escapes the resource curse. However, reduction in foreign receipts from the sale of horticulture, coffee and tea as well as the effects of a downturn in tourism caused by terrorism-related incidents may see the natural resources sector become a dominant part of the economy.

In illustration, Kenya's tea and coffee industries are susceptible to global market price changes—Fluctuating global tea prices saw a drop in revenue earned through tea and coffee exports in 2013. Kenya reported foreign exchange earnings of Ksh.94.6 billion in 2013 down from Ksh.122 billion in 2012 despite an increase in the amount of tea sold, up to 432.4 million kilograms in 2013 from 369.04 million kilograms in 2012. Additionally, coffee earnings dropped from Ksh.15 billion in 2012 to Ksh.10.4 billion in 2013.

The tourism industry has seen a decline in the number of visitors coming to Kenya with 1,780,768 tourists visiting in 2013 compared to 1,785,382 in 2012. This resulted in revenues earned from tourism dropping from Ksh.97.90 billion to Ksh.96 billion in 2013. This drop was

mainly attributed to pre-election anxieties, negative publicity, increased taxes and a rise in the cost of flying. With increased security concerns and terrorism incidents, the number of European visitors to Kenya has decreased. Indeed a number of western capitals have issued advisories against all but essential travel to Kenya.

Agriculture is the backbone of Kenya's economy. It contributes to 26% of the Gross Domestic Product (GDP) directly, employing 78% of the available labour force; 60% formally and 18% informally. While extractives may have the ability to plug some of the losses in foreign exchange they lack the ability to bridge the employment gap if these sectors were to continue to suffer downturns.

The macroeconomic profile has improved significantly in recent years, even if levels of poverty, lack of access to clean water, sustainable modern energy and other key indicators remain far from satisfactory. Faced with a crisis of investor confidence following the violence that accompanied the elections of 2007, the implementation of economic reforms has tamed inflation and encouraged steady GDP growth of around 5%[1]. In consequence, the country has taken significant steps towards meeting targets set out in Kenya Vision 2030. According to the World Bank, Kenyans now live two decades longer than they did at independence, infant mortality has fallen by 50%, and primary school enrolment is now almost universal[2].

In 2007, the disputed election of Mwai Kibaki was followed by bloody violence in the Rift Valley, mainly between ethnic Kikuyu and Kalenjin communities, leaving over 1,100 dead and many thousands displaced. Since, the ascension to power of the Jubilee Alliance, a coalition of President Uhuru Kenyatta and Deputy President William Ruto has attempted to build national unity. Many analysts interpreted the relative quiet of the March 2013 presidential elections as indicative of a country on the mend.

In 2010, Kenyans overwhelmingly voted in favour of the adoption of a new constitution, which devolves some government functions to the country's 47 counties, introduces a bill of rights and seeks to limit the enormous powers previously vested in the presidency. Gradually the country is adapting to this new framework, but the process of devolution has been slowed by teething problems as county governments familiarise themselves with their new responsibilities. The amount of money allocated to the counties has also proved a thorny political issue, and lead opposition party the Orange Democratic Movement (ODM), as well as county governors, have argued that devolved governments require more funding to fulfill their roles[3]. If the pace of discovery of oil and gas resources continues, the future revenues gained from these resources may become key points of conflict between national and county governments. A key discussion currently absent is the revenue management and use of the oil and gas resources. While provisions exist on percentages share of revenues between national and county governments in the constitution and other laws, there is no policy on ring fencing revenues at either the national or county levels.

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[1] See 'Kenya at the Economic Frontier: Challenges and Opportunities', Christine Lagarde (Kenya Private Sector
[2] 'Kenya Country Brief', *World Bank,* http://www.worldbank.org/en/country/kenya/overview
[3] "Governors pitch for more funds, insist that devolution must work at all costs", *Daily Nation,* 3 April 2014; "Give counties more money, Raila demands", *Daily Nation,* 24 August 2013

In a region marked by instability—with AU intervention in Somalia, which remains an extremely fragile state, and South Sudan becoming overwhelmed by domestic conflict—Kenya faces major security challenges. The September 2013 terror attack on the Westgate shopping centre by a group affiliated to the Somali Islamist movement Al-Shabaab highlights Kenya's vulnerability to revenge attacks for its involvement in Somalia—notably in taking Kismayo port in 2012. The Westgate attack also highlighted failings in the Kenyan security apparatus, damaged the tourist industry and brought millions of Kenyan-Somalis under increasing security scrutiny. There is also a risk to operators in the blocks close to the Somalia border. Indeed operators in Blocks 3A and 3B in Northern Kenya cited insecurity as one of the challenges that led to delays in operations[4].

Despite the economic upturn, as reflected in GDP growth, and Kenya's ability to tap international bond markets, the government is fighting a running battle against an uncontrollable public wage bill and there remains a perception (rooted in reality) that graft permeates even the higher echelons of government. Among high-profile recent developments, government plans to issue free laptops to Kenyan school children, a and mainstay of the Jubilee Alliance's election manifesto was undermined when it emerged that KShs1.4bn (US$16.2m) had been added to the tender when awarded to Indian company Olive Telecommunication[5].

In late June, the Ethics and Anti-Corruption Commission announced it was investigating several parliamentary committees over their alleged mishandling of funds for public projects. Among these is the Transport Committee which cleared the awarding of a US$4bn contract to the China Roads and Bridge Corporation to build the Standard Gauge Railway Project, linking Mombasa and Nairobi, in February. According to the Kenyan press, the investigations are focusing on alleged bribes paid to members of the committee prior to the contract being awarded[6].

In view of the susceptibility of oil and the broader extractive sector to corruption, the above illustrations are causes of concern. It is therefore crucial that steps are taken to ensure that the rent-seeking behavior so prevalent in other sectors does not hamper development in the emerging oil and gas sector. In the absence of an efficient legal framework the sector can be mostly opaque and could foster grand corruption. This would greatly undermine the development promise of oil for the Kenyan people. Paul Collier argues that while initially the resource curse was viewed in the economic lens of Dutch disease, it has now become clear that the interplay between politics and valuable natural resource is a big factor in the resource curse. Collier goes on to argue that the interplay between natural resources and politics does not necessarily—politics can affect natural assets and natural assets can affect politics[7].

[4] Canadian firm to sue Kenya over licences; http://www.standardmedia.co.ke/business/article/2000127495/canadian-firm-to-sue-kenya-over-licences

[5] "Sh24bn school laptops price mystery deepens", *Daily Nation*, 24 March 2014

[6] "House committees under probe for graft", *Daily Nation,* 28 June 2014

[7] Paul Collier : The political economy of Natural resources

majority remains impoverished. Examples abound in the Gulf of Guinea region—in states such as Gabon, Angola and Equatorial Guinea—a dependence on oil revenue has underwritten autocratic rule, eroding citizens' democratic rights. Kenya is not likely to depart from its current democratic path, but corruption could reduce the dividends of democratic governance.Kenya's progress towards becoming an oil-producing nation should be viewed in the context of the challenges stated above. Various jurisdictions across Africa provide pertinent illustration of the dangers of too swift an advancement towards oil production, without first laying adequate groundwork in the form of sector regulation, capacity-building and transparency provisions.

The political economy issues of oil are not in any way different from one country to the other. They involve competition for power, resources and influence. Policy-making could create the environment for winners versus losers; and access versus deprivation. These conditions only prepare the ground for major conflicts. In worst-case scenarios, such as Nigeria's long-standing hydrocarbons-producing conflict zone, the Niger Delta, high-level corruption, environmental degradation and inadequate mechanisms for accommodating local community interests in production areas have been major contributory factors feeding into criminality and insurgency at national and local levels.

It must be stated however that Kenya could become a model of how conflicts in an oil-producing environment can be addressed. The new Constitution of Kenya has laid a strong foundation for managing natural resources including oil and gas; dealing with revenue sharing challenges in the context of devolution; and providing a platform for public accountability. These attributes when mainstreamed into sector specific legislations and regulations will no doubt enhance the credibility of the government in its relationship with industry and citizens.

Oil: A Window of Development Opportunity?

Poised to become a crude oil producer, Kenya, stands at a crossroads. Having struck oil in January 2012, Tullow Oil plc, the most prominent international oil company (IOC) operating in the country, estimates its reserves could be 600 million barrels of crude oil; however, this figure could increase to 1 billion barrels within two years if further exploration is successful[8]. This would put Kenyan reserves on a par with Uganda's, and one-fifth the size of Ghana's. While this is not huge compared to the world's biggest reserves, production would nevertheless provide a substantial input into the economy.

The estimates of proven crude oil reserves indicated above are located in the South Lokichar Basin, and there are discussions between the contractor, Tullow Oil and the Government of Kenya to reach project sanction in the period 2015/16[9].

[8] "Special Feature – Kenya", *Tullow Oil*, pp. 28, http://www.tullowoil.com/files/pdf/special_feature_Kenya.pdf
[9] Tullow Oil plc - Trading Statement & Operational Update, January 15, 2014 (http://files.the-group.net/library/tullow/files/pdf_371.pdf)

The revenue contribution from oil could provide fiscal relief to the government to finance development interventions. With 600 million barrels of recoverable reserves, produced at 100,000 barrels per day, and based on a sale price of US$100 per barrel, our estimates of expected revenues to the government could reach US$1 billion annually with the potential to increase when the development costs are fully recovered. The government expected revenues will come from taxes, profit oil computed at US$50 per barrel and windfall profits. If these estimates hold, the earnings would bring the revenues at just below par with key sectors such as tourism and coffee, as discussed earlier.

Apart from revenues, there are also non-fiscal benefits such as leveraging on the oil and gas resources to add value to the economy. This can be achieved through what has become known as "local content". However, the implementation of local content is very difficult and countries that have promoted have faced challenges such as capacity, finance and institutional weaknesses. If local people are not provided with the requisite technical training, they cannot be absorbed by the oil sector. Similarly, if local firms do not have the financial strength to invest in the oil sector, they cannot compete. Above all, the country will not achieve local content objectives if the institutions given the mandate to enforce the requirements are weak.

There are good examples of how oil could be transformative and bring tangible development to the people when the revenues are invested productively and efficiently. In this regard Malaysia, Indonesia and Trinidad and Tobago provide important lessons for Kenya.

Oil could however come with dangers such as widening inequality, increasing poverty levels, weakening traditional economies (Dutch disease) and violent conflicts. Particularly, with a struggling manufacturing sector and Kenya's over-reliance on agriculture-fed economy, an occurrence of the dreaded "Dutch disease" could cause major setbacks to the economy. The collapse of Nigeria's ground-nut industry and Angola's Coffee industry are good examples of how oil can adversely affect traditional economies.

Kenya, whose oil industry is still in the exploration phase, has the opportunity to avoid such elements of the 'resource curse', and harness its oil wealth to drive economic growth and reduce poverty. However, while exploration and production work continues apace, Kenya's government, lawmakers and other stakeholders must not delay in putting in place the regulations, institutions and other structures to make the advent of oil and gas production an essentially positive experience in which the industry develops in a sustainable manner.

For the sector to develop in a way that benefits all citizens, input from civil society is vital—those voices must be heard to speak unanimously and clearly. This Agenda Setting Report lays out a common advocacy platform for Kenyan civil society groups focused on oil and gas. It identifies critical areas of concern requiring improvement and development, and makes policy suggestions where necessary as a contribution to creating a more equitable and prosperous Kenya. The report also highlights good and bad examples of countries that have travelled the journey Kenya is embarking on. These examples can help guide the government to avoid pitfalls and adopt good practices for the sustainable exploitation of Kenya's oil and gas resources.

SECTION 1

OVERVIEW OF KENYA OIL SECTOR

Photo by Boniface Mwangi

1.1 History of Kenya's Oil and Gas Sector

The search for oil in Kenya started as far back as the 1950s10. However, early wells drilled turned out to be dry. Between 1960 and 1984, 16 wells were drilled mainly in the Lamu and Anza basins. To accelerate the search for oil, the Government established the National Oil Company in 1981. The first comprehensive law to govern the industry, the Petroleum (Exploration and Production) Act was enacted in 1984. The Act was revised in 1986 when royalties were replaced by Production Sharing Contracts (PSC). From 1985 to 1992, a further 14 wells were drilled.

The Government decided at this point to undertake studies to establish the potential of some of the hydrocarbon basins. In 1995, a study on the Lamu basin was completed, and another one on the Tertiary Rift completed in 2001. Renewed attention on exploration commenced from 2000 during which offshore PSCs were awarded. A significant milestone in the development of the oil sector was the drilling of the deepest offshore well by Woodside energy and the deepest onshore well by CNOOC in 2006 and 2009 respectively.

After decades of failed efforts, which significantly reduced investor interest in Kenya's oil industry, Kenya became an area of intense exploration activity after the discovery of offshore gas in Mozambique and onshore oil in Uganda—both of which are believed to have the same geological conditions as Kenya.

In 2007 several companies signed PSCs for acreage in areas covering the counties of Mandera, Marsabit, Wajir and Garissa. These included Vancouver-based Simba Energy, which also has acreage in Guinea and Liberia, Canadian Lion Petroleum, owned by Toronto Venture Exchange-listed Taipan Resources, and Vancouver-based Vanoil which took Blocks 3A and 3B in Garissa County, covering parts of the Anza Basin.

Kenya continues to be a frontier—that is a region with potential for eventual oil and/or gas finds, but without the necessary level of discoveries or geophysical indicators and information to be constituted a new "hydrocarbons province". However, hydrocarbons finds made within the last five years by London Stock Exchange-listed Tullow Oil plc and partner Africa Oil Corporation (AOC) have turned Kenya into what is described as "*one of the most exciting exploration plays in East Africa*"[11]. Recent discoveries have fostered investor confidence in the country, and a number of larger firms have signed production-sharing contracts (PSCs) in recent years, boosting exploration activity, both onshore and offshore[12].

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[10] "Emerging East Africa Energy" *Energy Information Agency*, 23 May 2013.

[11] "Exploration activity in Kenya reaches unprecedented level", 215, *African Energy,* 9 September 2011

[12] See Appendix for full licence details and exploration activity

1.2 Recent Developments

Prior to 2012, only 33 wells had been drilled across Kenya's four sedimentary basins: Anza, Lamu, Mandera and Tertiary Rift. While 16 of these had made hydrocarbons finds (showing reservoirs containing oil or gas), none of these were considered 'commercial' (sufficiently large to merit investment in production). To date, the total number of wells drilled stands at 39.

The discovery in the Lokichar basin shows the Kenya has a significant hydrocarbon potential but this cannot be exploited without upstream investment. As can be seen from the following table, a large proportion of the total area of 491,396 square kilometers of the sedimentary basins have unknown potential. As at February 2014, only 80,000 square kilometers of 2D seismic data and 6,300 square kilometers of 3D seismic data had been acquired, a total of 86,300 square kilometers constituting only about 18% of the total basin area[13]. The investments required to unearth this massive potential resource could run into several billions of US dollars, which the government is unable to invest.

Table 1: Summary of the Basins and Wells Drilled

Basin	Area (km^2)	Wells drilled	Average Sediment thickness (m)
Lamu	261,000	19	12,000
Mandera	43,404	2	10,000
Anza	81,319	11	10,000
Tertiary Rift	105,673	7	4,000
Total	491,396	39	36,000

Ecobank estimates that Kenya's upstream sector requires funding in the tune of US$16 billion to cover cost of new wells development of the Lokichar find and the pipeline from North Turkana and completion of the Lamu Port[14]

The government must therefore create an environment that can attract upstream investments into exploration and development of infrastructure. This must be expressed in industry legislations and regulations. To this end, the Government has developed the Petroleum Exploration and Production Bill 2014 with the objective of promoting upstream investments.

[13] National Energy And Petroleum Policy - Final Draft - June 2014
[14] Middle Africa Insight Series 14 July 2014 available at http://www.ecobank.com/upload/20140714021923232353xZmRmzsNuU.pdf

The entry of Tullow Oil in 2011 has radically altered the investment prospects in Kenya's oil industry and it is believed that the discovery by the company would open the interest of more investors in Kenya's basins in the near future. Following the success it had enjoyed in several African countries, notably Ghana and neighbouring Uganda—where Tullow Oil discovered oil under Lake Albert in 2006 and now sits on an estimated 1.7 billion barrels of recoverable reserves—the company sought to test its theory that its finds beneath lakes in western areas of the East Africa Rift System might be replicated around lacustrine areas to the east, particularly in Kenya and Ethiopia.

Within 18 months of farming into Block 10BB, in Turkana County, Tullow Oil and Africa Oil Corporation (AOC) were ready to drill their initial Ngamia prospect; the spudding of this well was awaited in industry circles with much anticipation, which was warranted as Tullow Oil discovered 200m of net oil pay[15]. Subsequently, Tullow Oil has made a further six finds in the South Lokichar Basin.[16]

There is also increased exploration activity in the north and north-east, near the Ethiopian and Somali borders. Even though there has not been actual drilling, the companies involved have remained optimistic about the potential of those areas.

So far, there is evidence of growing interest of oil companies in Kenya which needs to be sustained through forward looking policies and the creation of an environment that gives assurance of security, profitability, and economic development. Out of the 46 blocks gazette as at June 2014, 44 had been licensed to oil exploration and production companies (OIEPs) and operated by 23 oil companies as detailed in Table below.

[15] "Jubilation and trepidation in equal measure as Tullow ends Kenya's long wait for an oil find", 228, *African Energy,* 29 March 2012

[16] See "Operational Update – Kenya", *Tullow Oil,* 27 March 2014, http://www.tullowoil.com/index.asp?pageid=137&newsid=883

Table 2 : License Petroleum Exploration Companies as at June 2014

No	Exploration Companies	Exploration Block Nos.	No. of Blocks
1.	Tullow Oil Corporation	10A, 10BB, 10BA, 13T, 12A,and 12B	6
2.	Anadarko	L-5, L-7, L-12, L-11A, L-11B	5
3.	BG Group	L-10A, L-10B	2
4.	Ophir/Dominion	L-9, L-15	2
5.	Apache (now withdrawn)	L-8	1
6.	Vanoil Resources	3A, 3B	2
7.	Africa Oil Corporation	9	1
8.	Zarara	L-4, L-13	2
9.	FAR/Flow Energy	L-6	1
10.	Lion Petroleum	2B	1
11.	NOCK	14T	1
12.	Simba	2A	1
13.	Afren	L-17/ L-18, 1	3
14.	A-Z Petroleum	L-1A & L-3	2
15	CAMAC Energy	L-1B, L-16, L-27, L-28	4
16	Rift Energy	L-19	1
17	Imara Energy Corp.	L-2	1
18	Adamantine Energy Ltd	11A	1
19	Pacific Seaboard Investments Ltd	L-20	1
20	ERHC Energy Inc.	11B	1
21	Lamu Oil Exploration	L-14	1
22	Total Exploration & Production Kenya B. V.	L-22	1
23	ENI Spa	L-21, L-23, L-24	3

With these recent developments, several questions linger on. For instance, can the government and its partners raise the capital for the development of the discovered fields? To what extent can the government finance other infrastructure projects such as the Lamu

Port, the proposed refinery and the pipelines required to support upstream operations and increase the commercial prospects of the discovery?

These questions impose on the Kenyan government and its partners the necessity for firming up project and investment decisions in the near future to bring the country's hope of being an oil producer to reality.

1.3 Future Development

1.3.1 Oil Exploration and Production

During the next two years, Tullow Oil plans to drill 19 exploration and appraisal wells in the country. Seven will be located in Block 13T, two in Block 10BA and nine in Block 10BB. As this report was being compiled, AOC was drilling the Sala prospect in the north-eastern corner of Block 9.

It is also expected that the government and Tullow Oil will work towards making project decisions in the next few years. So far, Tullow Oil has been able to resist being drawn into confirming when oil production will start. A company spokesman told our research team, "*no firm decisions on any aspect of production in Kenya have yet been made*," and the company has still to declare commerciality, although the project is well beyond the threshold for development.

In this case, there remain important stages to be completed before first oil. These include declaration of commerciality, submission of Plan of Development, financing and the development of the fields. This could take many years.

In addition, substantial milestones, including regional government alignment and support, approval of route, land acquisition and securing of financing need to be achieved before the pipeline becomes a reality[17]. That said, the ministry has set the ambitious completion date of November 2016 for completion of the pipeline, and Tullow Oil has said it could begin exporting an initial 10,000 barrels per day via road or rail in advance of full scale pipeline development[18].

Tullow Oil is certainly not in a rush to get to production as its experience in Ghana's Jubilee Field has shown that rushing the development of the fields could be costly years after commencement of production, with consequences such as unanticipated decline in production. However, the government is keen on getting early revenues as economic conditions get worse partly due to fiscal challenges. The next years are therefore very crucial in defining the milestones for the oil development projects.

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[17] See pp.29, "Special Feature – Kenya", *Tullow Oil*

[18] "Tullow looks to Kenya production options as Ugandan discussions drag on", *African Energy,* 260, 8 August 2013

In the next few years many of the prospecting companies will carry out planned activity. Some of these plans are outlined as follows:

i. Alongside Block 1's operator, Afren, in the Mandera Basin on the Somali border, Lion plans to drill the Khorof prospect;
ii. FAR, which operates Block L9 in the Lamu Basin, plans to drill an exploration well into late 2014.
iii. At the time of writing, Vanoil was locked in a dispute with the government over the future of its licenses. It had been forced to halt drilling and had to request a license extension in the face of community protests.

1.3.2 Gas Development

In terms of gas, developments have been slower. However in 2014 BG group and its partners confirmed they encountered an oil column possibly 14 metres thick beneath a gas column of 29.6 metres offshore in the Lamu basin. Africa Oil has also announced it made a gas discovery in block 9 although the commercial viability is yet to be determined.

Previously, Australia's Woodside Energy drilled the unsuccessful deep-water Pomboo well in 2006, and until mid-2010 development of the country's offshore was slow, with only a few Australian independents, including Flow Energy, Pancontinental Oil and Gas and Origin Energy undertaking any activity.

Since 2010, interest in the Kenyan offshore has picked up, following significant (potentially major) gas discoveries to the south in Tanzania and Mozambique. This has attracted a number of larger companies into the country.

In early 2010, US independent Anadarko signed up for all the country's farthest deep-water concessions. Anadarko's Kubwa well in Block L07 encountered non-commercial reserves of hydrocarbons. This was followed in May 2011 by the entry of UK company BG Group, which took two blocks, and by US-based Apache Corporation, which farmed into Block L8 (now withdrawn) and was soon joined by Tullow Oil. In September 2011, Total farmed into Anadarko's Blocks.

Such strong investor interest in the offshore prompted the Ministry of Energy and Petroleum (MEP) to demarcate eight new blocks, numbered L21 to L28, extending the country's acreage by 200 nautical miles into the Indian Ocean[19]. Italy's Eni took three of these blocks, while Total took one.

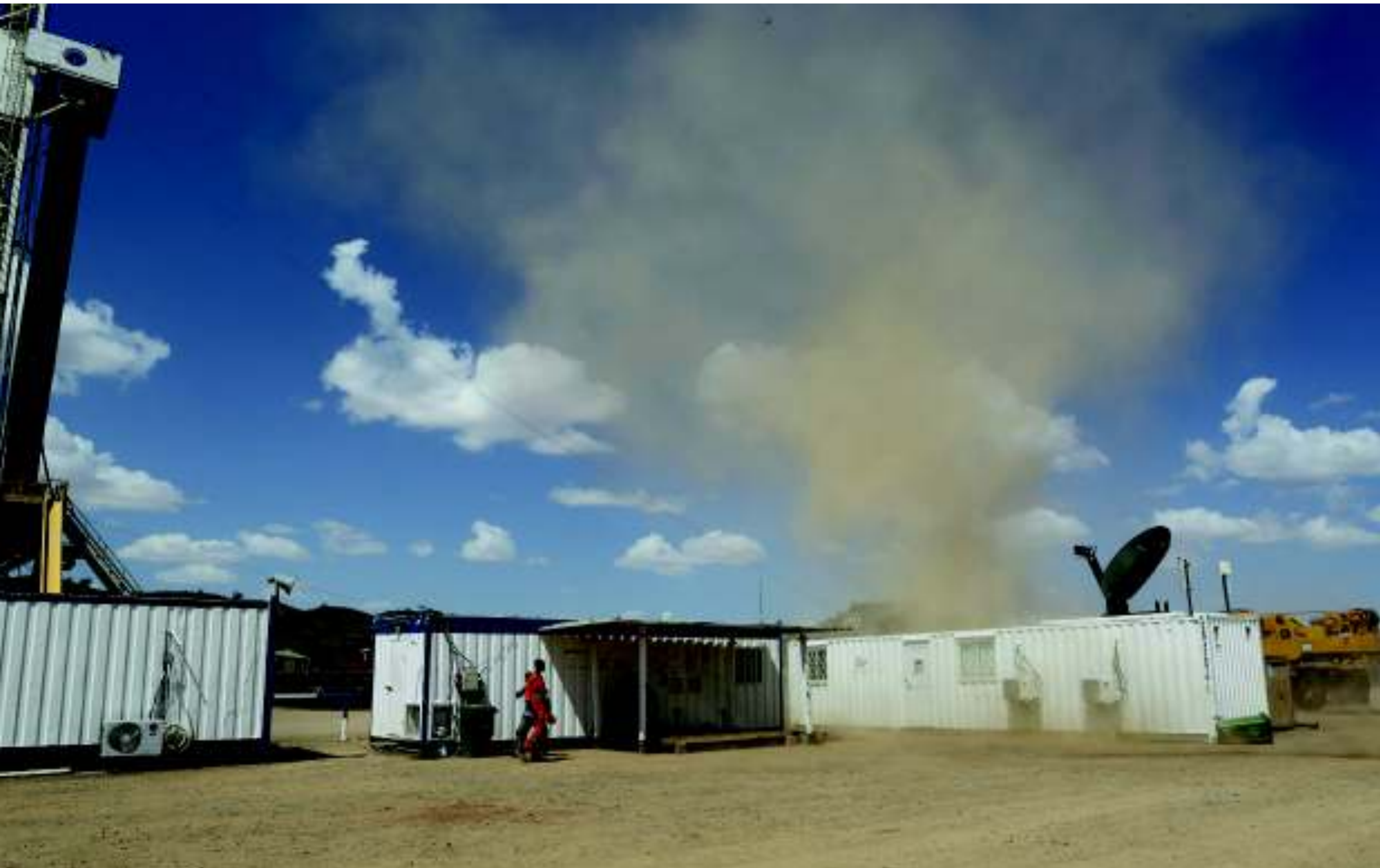
The recent announcement of discovery of gas offshore has raised expectations that the gas revolution in Eastern Africa could be extending to Kenya. This is particularly important for Kenya's industrialisation and its position as a regional hub. Indigenous gas from Kenya would facilitate investments in power generation to meet the growing demand for power for domestic and industrial use.

[19] Full details available at: "Kenya to offer new blocks", *African Energy,* 10 April 2014

This is particularly important for Kenya's industrialisation and its position as a regional hub. Indigenous gas from Kenya would facilitate investments in power generation to meet the growing demand for power for domestic and industrial use. It is for this reason the Vision 2030 development framework recognises the central role energy plays in driving the development efforts of the country. Its emphasis on the development of alternative sources of energy is inspired by the increasing cost of crude oil imports for use in thermal plants. A significant gas discovery would no doubt ensure the growth of affordable energy supplies.

SECTION 2

LEGAL AND REGULATORY FRAMEWORKS



2.1. Existing and new Legal Frameworks

Kenya's oil and gas industry is not without legal frameworks. There have been existing legislation that has been used to govern operations in the upstream oil sector thus far. Currently, the relevant legal frameworks for the industry include:

i. The Constitution of Kenya 2010.
ii. The Energy Act, No. 12, 2006
iii. The Petroleum Development Fund Act 1991
iv. The Petroleum (Exploration and Production) Act Cap 308 1986 revised edition.
v. The Petroleum (Exploration and Production) Regulations.
vi. The Environmental Management and Co-ordination Act, 1999
vii. The Environment and Land Court Act No. 19 of 2011
viii. The Geothermal Resources Act No. 12, 1982
ix. The Commission of Revenue Allocation Act, 2011
x. The Land Act 2012
xi. The Income Tax (Amendment) Act made to specify the fiscal regime applicable to petroleum operations

However, following the discovery of oil by Tullow Oil, efforts are being made to enact new legislation and/or review existing ones. Some of the new legal frameworks being consulted on at the moment include:

i. The Energy Bill, 2014
ii. The Petroleum Exploration, Development and Production Bill, 2014.

The Energy Bill is an integrated Bill covering upstream petroleum, downstream petroleum and the power sectors. The Bill is not intended to fully address issues in the upstream sector as its coverage of upstream petroleum issues is scanty and at best limited to broad policy objectives. The Petroleum Exploration, Development and Production Bill 2014 is therefore the industry specific Bill that seeks to address in

detail issues of upstream petroleum development. This section reviews some of the proposals in the Bill and analyses the extent to which they can address the major challenges already provided in the introductory section.

2.2. The Petroleum Exploration Development and Production Bill 2014

The Petroleum Exploration, Development and Production Bill will introduce a new model PSC for the sector, provide fiscal and contractual terms for natural gas which had previously been absent from legislation, articulate provisions for local content on employment, supply of goods and services, training of Kenyan nationals and cater for local communities[20].

The Bill also contains provisions covering ministerial authority, operations of the National Oil Company and environmental management, among others. The Bill when passed into law will repeal the Petroleum (Exploration and. Production) Act of 1986.

In the next part, the main features of the Bill are highlighted for emphasis.

2.2.1. Key Features of the Petroleum Exploration, Development and Production Bill

The Bill provides for the following to govern upstream petroleum operations:

a. A National Policy for Upstream Petroleum Operations. The policy is supposed to be reviewed every 5 years.

b. Ownership rights of the state over petroleum resources. This vests petroleum resources in the Government in trust for the people.

c. Integrated development of oil fields and common use of infrastructure which ensures that discoveries in two separate blocks can be developed as a unit operating area using common infrastructure.

d. Distribution of the Government share of petroleum revenues shall consist of 75% to the Central Government, 20% to the County Government and 5% to the local community where oil is being extracted.

e. Local content in the Bill recognises the concept of "local-local content" in which communities near extraction are given first preference in the provision of services. It also provides for a Training Fund which will be used to finance capacity development of local personnel.

f. Environmental provisions include the Polluter Pay Principle in which oil companies are fully liable for any pollution or damage caused by petroleum operations.

g. Community rights including the right to be consulted before the commencement of an oil project, and the right to adequate compensation when petroleum operations adversely affect their interest.

[20] It is worth noting that in recent statements regarding the Petroleum (Exploration and Production) Act amendments, the Government has used the phrase “national content”, rather than “local content”. According to a statement on the MEP website: “the term ‘national content’ has been adopted instead of ‘local content’ since ‘local’ may be misconstrued to mean particular communities where oil and gas operations are being conducted”.

h. Licensing of oil concessions through competitive public tender. This limits the influence of politicians and bureaucrats in the award of Petroleum Agreements.

i. Transparency in the oil industry, a commitment to publishing information on production volume, petroleum revenues, and other relevant data on a project-by-project basis.

These features are not exhaustive and contain more details than currently provided in this report. The Platform will publish a detailed analysis of the Bill in another volume to ensure that citizens are informed and can participate in debates on the Bill.

2.2.2. Shortcomings of the Petroleum Exploration, Development and Production Bill

The Bill is one of the most progressive laws in the history of Kenya's oil and gas sector. However, a review of the Bill conducted by the Platform has revealed serious shortcomings that are likely to adversely affect the management of oil and gas resources in the country.

The shortcomings must inform engagement between key stakeholders including civil society groups, public officials and members of parliament with the view to amending the Bill as parliament prepares to consider it, or through other legal frameworks that are yet to be developed.

Key areas of concern about the new Bill are:

i. It combines issues of petroleum exploration, development and production with petroleum revenue management and local content. As a result of this amalgamation of what should be in separate legislations, most of the clauses are not as detailed as would be required to ensure clarity, regulatory certainty and smooth enforcement.

ii. It does not make provision for an investment framework for managing petroleum revenues as well as clear rules for petroleum receipts and withdrawals from the Sovereign Wealth Fund which the government plans to create.

iii. It gives the Cabinet Secretary too much discretionary power and unless this is regulated, the potential for abusing this power is very high.

iv. It does not make detailed provisions on local content. This could be addressed by regulations but this also defeats the argument behind consolidating several laws in one piece. The same issue applies to provisions on petroleum revenue management.

v. As a potential gas boom country, it is not appropriate that the Bill ignores important provisions on gas development, its pricing and utilisation.

vi. There is no comprehensive contract transparency regime in the Bill. The new reporting requirements of the Extractive Industries Transparency Initiative (EITI) such as mandatory contract disclosure, reporting on winning bids and justifications during a public tender licensing for oil blocks, disclosure of beneficial ownership information, reporting on expenditure from oil revenues have not been covered in the Bill.

vii. The Bill does not provide a mechanism for financing the National Oil Company of Kenya (NOCK) from the government's share of oil/revenues. This has become very important issue in countries that limit their national oil companies to commercial operations which require capitalisation. A transparent model for capitalising the NOCK must be an important feature of this Bill.

viii. It is silent on domestic supply obligation of oil companies. Since the government is considering building an oil refinery, it must recognise that its share of petroleum may not be sufficient for domestic consumption and may require oil companies producing oil in the country to commit their share to the domestic market. Even in cases of an emergency, when the country needs to store more refined products, the only option open to it is oil produced in the country.

ix. It does not make provision for joint development zones in cases when oil straddles the border with Kenya's neighbors. This is despite the fact that Kenya borders equally promising oil basins on the side of South Sudan, Somalia and Uganda and there may be compelling cases for joint development of the reservoir between Kenya and any of these neighbors. Even though the Bill provides for unitisation, its coverage is limited to contract areas within Kenyan jurisdiction and not across jurisdictions.

x. In spite of the high risks of corruption in the oil and gas industry, the Bill does not incorporate anti-corruption clauses consistent with major international benchmarks such as the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, signed in Paris on December 17, 1977, which entered into force on February 15, 1999, and the Convention's Commentaries; the United States of America Foreign Corrupt Practices Act 1977; and the United Kingdom Bribery Act 2010.

SECTION 3

INSTITUTIONAL FRAMEWORK

3.1. Existing Institutions

This section examines the key institutions and individuals administering Kenya's oil and gas industry, and locates a significant threat to good governance in the fact that significant discretionary powers are vested in the government. It also assesses whether current and proposed institutional arrangements are adequate in addressing the governance challenges of the petroleum sector.

3.1.1. Ministry of Energy and Petroleum (MEP)

The Ministry is headed by the Cabinet Secretary who presides over policy-making and supervises departments and agencies under the Ministry. In the upstream sector, the role of the Cabinet Secretary covers policy-making to manage oil and gas resources, sponsoring bills into Parliament to be passed into laws, and negotiating and granting Petroleum Agreements. The role of the Cabinet Secretary is defined in the Petroleum (Exploration and Production) Bill which also gives him/her regulatory powers.

The Cabinet Secretary's role in petroleum licensing is the most critical area of governance in the petroleum sector. Petroleum Agreements provide room for rent seeking behaviour and corruption through abuse of discretion. In some cases, there arise serious conflicts of interest where the Cabinet Secretary may have an interest in the process he administers. Under this circumstance, unlike members of Commissions or Boards, Cabinet Secretaries do not recuse themselves from managing the process. This undermines the interest of the state as the terms of negotiated Petroleum Agreements are used to seek favours from oil companies as a result of which the national interest is compromised in favour of individual interest. This is why there is a strong need for checks and balances in the role of the Cabinet Secretary.

3.1.2. National Oil Company of Kenya (NOCK)

As the National Oil Company, NOCK represents and holds the Government interest in all petroleum operations. In the past, it performed both regulatory and commercial roles but in recent times, it does not exercise any regulatory powers. Its principal role is now that of a mainstream oil company, developing oil and gas exploration and production operations with partners.

It is important to state however that even though policy-making for the upstream petroleum sub-sector is the responsibility of the Cabinet Secretary, NOCK still retains some policy influence by providing "*policy advice and support to government by making recommendations*"[21], according to Sumaya Hassan-Athmani, CEO of NOCK.

Despite its existence for some time now, there is evidence of limited capacity in NOCK to harness the full potential of the hydrocarbon basins in the country. Thus, in order to fulfill its function as the commercial arm of the government in petroleum activities and to make

[21] Research Team interview, Nairobi, 12 March 2013

recommendations to the ministry, NOCK's internal capacities require upgrading. This lack of capacity was a concern mentioned by several interviewees who offered their experience and opinions for this report.

NOCK has a capacity-building programme under way, but the consensus among interviewees – both Kenyan and international – is that there is much room for improvement[22].

3.1.3. Energy Regulatory Commission (ERC)

The primary responsibility of the ERC is regulation of the sector. As regulator, the ERC approves operational permits and authorisations and also enforces compliance. With powers "*to issue, renew, modify, suspend or revoke licenses and permits for all undertakings and activities in the energy sector*," the ERC's authority is wide-ranging[23].

However, as mentioned earlier, the role of the ERC conflicts with the powers of the Ministry of Energy and Petroleum under the Cabinet Secretary. Therefore, whilst ERC is formally independent, in reality, it has been rendered redundant in its function as a check and balance on ministerial decision-making in the oil and gas sector.

The independence of the ERC further compromised because while the president appoints the chairperson—giving him/her some extra weight provided the head of state remains above day-to-day involvement in the sector—all other commissioners are appointed by the Cabinet Secretary for Energy, including one commissioner from the MEP itself. This effectively limits the ERC's independence, meaning it cannot be relied upon to curtail political involvement in the sector.

3.1.4. National Fossil Fuels Advisory Committee (NAFFAC)

The National Fossil Fuels Advisory Committee (NAFFAC) is the licensing arm of the government. Created largely to assist the Cabinet Secretary in negotiations with would-be contractors, NAFFAC is an inter-ministerial committee comprised of the ministry's principal secretary as chairperson and NOCK's managing director as secretary.

NAFFAC's other members are the Attorney General, Principal Secretary of the National Treasury, Commissioner of Petroleum, the MEP's Chief Geologist, National Environment Management Authority (NEMA) Director General and Commissioner of the Kenya Revenue Authority.

3.1.5. Parliament

Parliament has an important role to play in the oil and gas sector as a representative of the people. Its central role is oversight on all executive actions. In the petroleum sector, as already stated, the responsibility for negotiating and granting Petroleum Agreements is conferred on the Cabinet Secretary. The Petroleum (Exploration

[22] Research Team interview, MP for Wajir East Mohamed Elmi, Nairobi, 11 March 2014; Research Team interview, KCSPOG representative, Nairobi, 12 March 2014

[23] Energy Bill, 5th draft, Part III.13.1.a

and Production) Act of 1986 does not provide for parliamentary ratification of Petroleum Agreements granted by the Cabinet Secretary. However, Article 71 (1) a of the Kenyan Constitution, guarantees that "*A transaction is subject to ratification by parliament if it involves the grant of a right or concession by on behalf of any person, including the national government, or another person for the exploitation of any natural resource of Kenya*,"

This is a major improvement on the Petroleum Act of 1986 as the Constitution is recent, drafted several years after the Act was passed.

It must be stated nevertheless that upstream oil discovery is new in Kenya and parliament cannot over a short period of time master the expertise to understand the complex and technical matters involved in the sector, including scrutinising Petroleum Agreements. The capacity challenge in parliament therefore limits its oversight power giving the Cabinet Secretary and Agencies of the State free license to undermine the licensing process.

3.2. Institutional Reforms in the Upstream Petroleum sector

Following the discovery of oil in the country, the Government embarked on institutional reforms with the aim of building a strong institutional environment for regulating the upstream petroleum sector. The proposed reforms have been compiled in the new Petroleum Exploration, Development and Production Bill 2014. The proposals seek to create new institutions and to realign the role of some existing institutions. Two new institutions have been proposed - a National Upstream Petroleum Authority and a National Upstream Advisory Committee. The roles of these institutions are explored below.

3.2.1. National Upstream Petroleum Authority

The authority shall be the regulator of upstream operations. The main functions of the Authority shall include:

a. regulate upstream petroleum operations in Kenya;
b. provide such information and statistics to the Cabinet Secretary as may be required from time to time;
c. collect, maintain and manage upstream petroleum data; and
d. doing or performing all other acts for the furtherance of the provisions of this Act which may lawfully be done or performed by a body corporate.

Unlike the ERC which has regulatory oversight on the entire energy sector, the Authority's role will only focus on only the upstream sector. The ERC will therefore stop its coverage of upstream operations. Since the upstream sector is very challenging and requires specialised knowledge and closer attention, the practice in oil producing countries has been to establish an industry regulator to oversee its operations. The proposal in the Bill is therefore consistent with modern trends in petroleum regulations but as is explained later, the structure and functions of the regulator may be such as to reduce it to an appendage of the political establishment.

3.2.2. National Upstream Advisory Committee (NUAC)

This Committee will take the entire role of the National Fossil Fuels Advisory Committee (NAFFAC). It is not clear yet if NAFFAC will be abolished or assigned other responsibilities. The primary role of the Committee is to:

a. participate and advise the Cabinet Secretary in the negotiation of petroleum agreements and in the granting and revocation of licenses;
b. submit a report to the Cabinet Secretary on the terms negotiated with contractors;
c. advise the Cabinet Secretary on upstream petroleum operations;
d. participate in the evaluation of the bids and applications for awarding petroleum blocks;
e. conduct all due diligence and investigate all the affairs of contractors prior to entering into petroleum agreements;
f. advise the Cabinet Secretary on the grant of non-exclusive exploration permits, in respect of areas specified therein, under which a person may enter upon an area to prospect and/or carry out geological, geochemical and geophysical surveys as may be provided in the permit

NAFFAC is relegated to a purely advisory role. Given the expertise contained in the body, the proposed reforms will likely miss the opportunity of making the Committee another layer of governance. In its current form, the proposal for an upstream advisor committee does not appear to be appropriately established by statute since in most jurisdictions the establishment of such advisory committees is purely administrative.

The composition of the Committee will also differ from that of NAFFAC as follows.

a. Principal Secretary or alternate in the Ministry responsible for Petroleum who shall be the Chairperson;
b. Chief Executive or an authorised representative of the National Oil Company who shall be the Secretary;
c. Attorney General or an authorised representative;
d. Principal Secretary of the National Treasury or an authorised representative;
e. Director General, National Environmental Management Authority or an authorised representative;
f. Commissioner General, Kenya Revenue Authority or an authorised representative; and
g. Principal Secretary in charge of mining or an authorised representative.

The new Committee will have a representative from the Ministry of Mining but will exclude the Commissioner of Petroleum and MEP’s Chief Geologists.

3.3. Institutional Best Practices for Managing the Oil and Gas Sector

The reason for establishing an independent industry regulator is to insulate ministerial powers from regulatory powers, limit the minister to policy making, protect the process of a fair licensing regime, and to limit undue political influence in petroleum regulations. This is often called the Norwegian model but is practiced also in Nigeria.

In spite of this progressive proposal, the Authority is likely to face some challenges in executing its operational functions partly because its role is limited to post licensing operations. The Authority does not have a role in the licensing process and even one of its major responsibilities as practiced in different countries, the conduct of due diligence on applications for petroleum license, has been given to the proposed Upstream Advisory Committee, which advises the Cabinet Secretary on grant of licenses. Moreover, the Cabinet Secretary shall exercise operational regulations, thus conflicting the primary role of the proposed Authority. Furthermore, the Director-General of the Authority shall be appointed by the Cabinet Secretary for Energy. These proposals do not intend to provide the upstream regulator any iota of independence as done in most progressive jurisdictions.

In Ghana for example, the Petroleum Commission, the industry regulator, is fully responsible for upstream regulations, it is the only Advisor to the Minister of Energy and Petroleum on upstream petroleum matters, and conducts due diligence on applications for petroleum license. The Chief Executive Officer is appointed by the President.

In Sierra Leone, the regulator has similar roles as Ghana's. The difference is in the appointment of the head of the institution. Sierra Leone's Petroleum Act of 2011 requires that the appointment of the Director General of the Petroleum Director (industry regulator) must be ratified by parliament.

The main observation here is that whilst in theory, the proposal in the new Bill is in line with the more progressive models, in character, the proposal falls short of what makes a regulator independent. Therefore, there are significant governance risks associated with the proposal with the likelihood of conflict of interest on the part of the political head. Further, the danger associated with this proposal is that the National Upstream Petroleum Authority will be reduced to a department under the Cabinet Secretary, and with his powers, the potential for rent seeking; corruption and abuse of discretionary powers will be very high.

It is clear from the institutional reforms being proposed in the Petroleum Exploration, Development and Production Bill 2014 that Kenya is not likely to improve on good governance in the petroleum sector if the Bill is passed into law in its current form. Already, early worrying signs in previous licensing of oil blocks have sought to confirm the theory that a country with weak institutional frameworks could be the destination for "rogue companies". The licensing saga of Block 10BB serves as a pertinent example of how opportunistic companies can use political connections to rapidly make undeserved millions of shillings.

In addition, the government's hesitation to issue licenses through bid rounds Kenya has licensed 44 blocks, but never held an auction has encouraged business among middlemen in the country.[24]. Whilst the involvement of middlemen in the licensing process is not necessarily illegal, it certainly does not constitute best practice and the interests of Kenyans in obtaining a fair deal from their oil and gas reserves would be better served through the holding of an open and competitive bid round.

A criticism of this system is that it could favour smaller but politically connected companies – and that, consequently more experienced and well-resourced explorers might lose out to companies less able to fulfill their work commitments. This would act against the interest of Kenyans.

[24] "Kenyan middleman", *African Energy*, 230, 3 May 2012

KCSPOG
The Kenya Civil Society Platform On Oil & Gas

SECTION 4

REVENUE MANAGEMENT

4.1. Revenue Management

Oil revenues have the potential to encourage economy-wide growth if managed appropriately. However, if managed badly, oil revenues risk economic challenges of inflationary pressure, weak export industries, and cyclical government expenditure, not to mention the challenges of corruption, patronage and conflict. "*The potentially substantial revenues from the oil and gas sector will come with significant challenges, that require careful management*", said Diarietou Gaye, World Bank Country Director for Kenya[25]. "*Kenya has a window of opportunity of a few years to take the right steps that will determine the shape of the oil and gas sector for decades to come*".

4.1.1. Kenya in Search of a Model for Petroleum Revenue Management

There are different models of managing petroleum revenues productively and ensuring the transformation of revenues into visible development outcomes. These models attempt to answer the following political economy questions:

i. How much to spend and save? and

ii. Where to spend or invest?

How much to spend of petroleum revenues is dictated by a number of factors including the level of absorptive capacity, macroeconomic stability and the need for fiscal sustainability as a result of the non-renewable feature of petroleum revenues.

Petroleum revenues therefore must be managed in the context of an overarching macro-fiscal framework that recognises the volatility, uncertainty and cyclical nature of prices, and over time the exhaustibility of oil resources, ensuring they are linked to national budget processes. The most common models on how much to spend are those based on the "hand to mouth" rule, the "bird in hand" rule and the "permanent income" rule.

The hand-to-mouth rule requires that the government spends all revenues generated through the annual budget. This rule is used mostly by countries where the size of revenues is insignificant, or where development challenges are enormous. Norway adopted this model until 1990 when it set up a savings fund.

The bird-in-hand rule requires that petroleum revenues are put in a Petroleum Fund and invested in financial instruments whilst the government spends only the returns on the investments. This is the current rule Norway is applying to the management of its petroleum revenues. The Fund invests its assets abroad to reduce the appreciation of the real exchange rate, but rules regarding inflow and outflows remain flexible.

[25] Ibid.

The permanent income rule allows the spending of the discounted net revenues annually computed over the life span of the investment project. This ensures that a permanent proportion of the size of the petroleum wealth is spent every year into eternity, whilst the balance invested through a Sovereign Wealth Fund continuous to grow beyond the life of the project.

Most resource rich countries have adopted one model or the other depending on the stage of development of the oil and gas industry and the size of revenues being generated. Deciding what Kenya should do with its petroleum revenues is a political decision, which is linked to legal, economic and social considerations.

The Government of Kenya proposes to establish a Sovereign Wealth Fund to which the Central Government share of petroleum revenues will be transferred. This Fund will be used for budgetary support, stabilisation of the budget and for future generational equity. However, it is not clear yet what fiscal rule the Government will adopt to determine the size of annual spending from the Fund.

On the question of where to invest petroleum revenues, the three most common investment priorities include the agricultural development model, the industrial development model and the human capital model. These models are defined by the development priority that receives the largest proportion of petroleum revenues. For instance, Indonesia applied the agricultural development model because it is believed that it facilitates faster redistribution of revenues. Since the bulk of the population in developing countries lives in rural areas where peasant farming is the major occupation, an investment in agricultural development directs resources to rural farmers to accelerate poverty reducing productivity.

On the other hand, Malaysia focused on industrial development by spending its petroleum revenues in industrial infrastructure such as roads, electricity, water and ICT. Industrial spending speeds up economic growth, and when this growth is sustained over a long timeframe, it translates into development.

Trinidad and Tobago on its part invested heavily in education, skills and innovations. This model helps to build an educated workforce capable of generating wealth through value addition. This model injects growth in the economy whilst maintaining the social development objective of human capital development.

There is no doubt that in the area of investing petroleum revenue, the Kenyan Government is once again in search of an appropriate model that can contribute to economic growth and development. In its proposal in the Petroleum Exploration, Development and Production Bill, the government has expressly articulated its priority in infrastructure development, but whether the focus will be on social infrastructure like education and health, the path Botswana took, or economic infrastructure or commercial infrastructure like that of Malaysia remains uncertain.

Most of the countries cited above legislated their models for petroleum revenue management. However not all countries have the same high level of fiscal discipline, hence the outcomes of these models have been mixed. One example of fiscal indiscipline is Chad, which had an excellent piece of legislation developed at the insistence of the World Bank as condition for funding the Cameroon-Chad export pipeline.

The legislation required strict withdrawals of revenues as well as provided for investment and savings rules. The legislation introduced by the Government in 1999, provided that 10% of the total revenues would go towards a fund for future generations, held in an account at a development finance institution, 80% was to be spent on priority sectors of public health, social affairs, education, infrastructure, agriculture, livestock and water, with the remaining 10% split equally between the oil producing region and normal government expenditure.

In addition, whenever the government wanted to allocate expenditure, it had to seek approval of the *Collège de contrôle et de surveillance des ressources pétrolières* (The Petroleum Revenue Oversight and Control Committee), an independent body comprised of representatives from government and civil society. However, by 2006, the government had abolished provisions directing 10% of revenue towards the fund for future generations, directing it instead towards its priority areas. To these, it added energy, justice, security and territorial administration, allowing it to effectively spend the money on whatever it wanted, but mostly to buy weapons. This indeed also demonstrates that legislation alone is insufficient to guarantee successful management of petroleum reserves.[26]

The lesson from Chad's example is that a revenue management model is a necessary, but not sufficient, condition to ensure the transformative effect of revenues. Transforming petroleum revenues into development also require a sustained fiscal discipline and strong institutions capable of enforcing the restrictions on withdrawals, spending and savings.

Box 4. Sovereign wealth fund

Petroleum funds are designed to protect the economy from overheating, safeguard against excess volatility in government spending, and enhance the scope for transparency and oversight. Petroleum funds, in their many guises, are increasingly popular in oil economies, but have a mixed record of success.

Kenya's Sovereign Fund is provided for in s.136 (1) of the Energy Bill. *"The Cabinet Secretary shall determine, with the approval of parliament (a) the amounts payable into the Fund; (b) the asset manager to manage the Fund; and (c) the withdrawals made from the Fund – provided that the mount payable into the fund shall be at least 5% of the government share of proceeds"* (s.136(3)). The asset manager has broad powers to invest the funds as he/she sees fit, providing they are in line with broad objectives.

While funds can provide for positive revenue management arrangements (in Norway for example), if they are managed poorly, they can raise corruption worries (in Angola for example). To ensure Kenya resembles the former, rather than the latter, strict powers of oversight must be devised. In Sao Tome and Principe, for example, a rigid formula determines the maximum annual withdrawals from the fund and requires the signature of four officials from different parts of the government.

As already observed elsewhere in this report, the government is perhaps paying less attention to the

[26] "Chad: Escaping from the Oil Trap," International Crisis Group report, 26 August 2009

complexities of petroleum revenue management and its potentially devastating impact on the economy such as Dutch disease, non-productive spending, inflation and corruption. Rather than enact a specific legislation on petroleum revenue management with clear transfer and withdrawal rules as well as investment and savings rules, the government has included a few sections on revenue management in the Petroleum Exploration, Development and Production Bill 2014.

4.1.2. Revenue Management in the context of devolution

One of the central purposes of Kenya's adoption of a new constitution in 2010 was to devolve many of the functions which were previously the responsibility of central government to the counties. The new constitution hopes to improve the capacity of local government institutions, making them better able to provide for the citizens they represent, thereby reducing conflict in the country.

Since independence, devolution has been a controversial issue in Kenya, and implementation of the new system is beset with teething problems made no easier by an apparent reluctance to devolve on the part of the ruling central governments.

Revenue from central government is distributed to the counties via a special government formula which aims at equitable distribution of funds, taking into account criteria such as poverty levels and population.

Yet despite this formula, many counties, particularly those in the impoverished north, such as Turkana, Marsabit, Mandera and Garissa (all counties with oil exploration activity), have struggled to balance their budgets, despite the additional funding they receive courtesy of the government formula. In part, this is due to a combination of county governments' inability to raise its own revenue through taxation and the need for increased funds from central government—this year's allocation will be Ksh.58 billion (US$667 million) less than last year—however, a lack of capacity, corruption and economic mismanagement also play a role in the shortage of funds.

In some oil producing countries, a proportion of petroleum revenue is ceded to local areas especially where oil and gas resources are being extracted. This is based on the principle that although natural resources are the property of the state and benefits must be shared by all; those who are affected more by extraction must be allocated more benefits to compensate against the negative effects of extraction.

Different revenue sharing mechanisms have therefore been employed in different jurisdictions. Nigeria has the derivative formula, which allocates 13% of total petroleum revenues to producing states. In Chad, 5% of total petroleum revenue is distributed to the producing regions. The proposal in Kenya is to distribute 20% of the government's share of petroleum revenues to the county government and 5% to local communities where there is extraction of oil.

The adoption of this principle falls in line with best practices as it helps with managing community dissent and conflicts that arise from the disaffection by communities who feel their rights to their heritage, livelihoods and environmental sustainability have been infringed upon. Where the development needs of such communities are not addressed, it could lead to violent conflicts and production disruption, with grave consequences for revenue inflows to the National Treasury. The case of Nigeria's Niger Delta is a good example.

However, as expressed earlier, some counties have low absorptive capacity to manage ceded revenues and are therefore likely to invest revenues in non-productive areas or used for recurrent expenditure. Also, patronage in the distribution of benefits at the county level could increase contestations among the people over resources leading to internal conflicts.

In the context of existing issues concerning county governments' budget management, the lack of procedure over how local governments spend ceded petroleum revenue is a cause for concern. Add to this the fact that oil production, when it starts, will take place in areas where historically, strong ethnic and community rivalries increase competition around strong resources, and the potential for conflict is greatly increased.

Aside from exacerbating local conflict, distribution of revenue to county governments, if improperly legislated for, also runs the risk of shifting corruption from central government to devolved government, as has been the case in Nigeria.

4.2. Financing the National Oil Company from the Government share of Petroleum Revenues

Clearly, one of the contentious issues in oil revenue management is financing oil investments by the National Oil Company from the Government share of petroleum revenues. Apart from the genuine desire for investments, National Oil Companies in most cases operate under secrecy and are often not subject to public scrutiny or parliamentary oversight.

Corrupt governments therefore transform them into slush funds, transferring a lot of oil money to them and returning through the "back door" to draw the funds for non-productive spending including for political projects.

Although NOCK is playing an important role in the oil and gas industry and aims to become a competitive commercial entity, there is no known proposal on how the company's operations and investments will be financed from petroleum revenues.

There are different models for financing NOCs. In Liberia, NOCAL, the National Oil Company of Liberia, is required to receive the state's share of petroleum revenues, hold back not more than 25% and transfer the balance to the Government Treasury. This does not promote transparency and accountability since the company can inflate its budget through unnecessary spending and waste in its quest to retain a substantial share of the revenue even if it cannot justify it.

In Ghana, all petroleum revenues go to the Petroleum Holding Fund before the NOC's share is transferred to it. For purposes of good governance, Ghana's option is preferable since the transfer is done through a transparent budget process and approved by Parliament.

4.3. Revenue Assessment and Collection

Revenue collection is one of the biggest challenges of resource rich countries. The oil and gas sector is associated with huge illicit financial outflows from countries that do not have sufficient mechanisms and capacity to address them. Tax avoidance schemes that reduce the tax base for most countries which then reduce tax revenues, include trade mis-invoicing through transfer pricing, and base erosion through thin capitalisation. This is often compounded when companies are incorporated in tax havens.

Global Financial Integrity reports that from 2002-2011, Kenya lost tax revenues of about US$9.64 billion through trade mis-invoicing, which constituted about 8.3% of total tax revenues and 288.6% of Official Development Aid received by Kenya over the period[27]. The revenue losses were mainly from export over-invoicing. This is notwithstanding that Kenya has anti-avoidance tax instruments including transfer pricing and thin capitalisation rules.

The entry of many multi-national oil companies in Kenya's oil and gas industry, most of which are incorporated in tax havens raises the prospects of further revenue losses to the country. For instance, Tullow Oil draws 84% of its revenues from Africa, but only 4 out of the 81 companies it lists as subsidiaries are registered in African countries[28]. Most of the subsidiaries are registered in tax havens including British Virgin Islands, St. Lucia, the Channel Islands and the Netherlands.

With oil exports likely to commence in a few years, export under-invoicing will likely feature in the oil industry. There is no doubt that Kenya will be confronted with further revenue losses from oil export unless the right mechanisms are put in place through tax authorities to ensure that the state maximises its collection of oil revenues.

The institutions of State involved in revenue collection must be supported to prevent the erosion of the oil company tax base by effectively conducting cost and profit audits on the operations of oil companies. The Kenyan Government must therefore begin to review its tax-avoidance rules to make them compatible with global rules and more so to make them effective tools for addressing illicit capital outflows through the oil industry.

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[27] Raymond Baker, Christine Clough, Dev Kar, Brian LeBlanc, Joshua Simmons, (2014) *Hiding in Plain Sight: Trade Misinvoicing and the Impact of Revenue Loss in Ghana, Kenya, Mozambique, Tanzania, and Uganda: 2002-2011,* May 12, 2014 .

[28] The Guardian "UK's top companies condemned for prolific use of tax havens" Sunday, 12 May 2013

SECTION 5

TRANSPARENCY AND ACCOUNTABILITY

Photo by Boniface Mwangi

This section assesses the extent to which Kenya has taken the necessary steps, both legislatively and institutionally, to manage oil contracts and revenues in a way that encourages sustainable growth, and equitably distributes income among counties and communities, which have been affected by the processes of exploration and exploitation.

The section also considers the extent to which Kenya's oil industry is formally committed to principles of transparency, and how this is guaranteed by existing and proposed legislation governing the sector.

Transparency shines light on secrecy and unearths the cost of opaque deals to the state, communities and citizens.

In this section, three levels of transparency benchmarks have been reviewed – contract transparency, revenue transparency and international transparency initiatives.

5.1.The need for Transparency and Accountability in the Oil and Gas Sector

Oil is a lucrative business. However, the African experience has been such that resource wealth does not spur inclusive and sustainable development, unless partnered with rigorous good governance, transparency and accountability. However, the presumed 'resource curse'[29] is not linear.

In the 1950s, oil-rich Indonesia and Nigeria were both newly independent states with similar GDP per capita. By 2000, Indonesia's per capita income was four times that of Nigeria; today, 46% of Nigerians still live in poverty, compared to 14% of Indonesians[30]. Learning from these mixed experiences, principles of transparency and accountability are considered paramount in ensuring that oil is a blessing, rather than a curse.

Without transparency, citizens cannot ensure that oil revenues contribute to socio-economic development.

A proliferation of global initiatives, summarized in has emerged to drive transparency in the oil industry. International norms increasingly require that the terms of oil contracts are made public, and that companies publish what they pay.

However, whilst transparency can arm citizens with information about government finances, it cannot by itself create the constituencies or mechanisms of accountability that are critical in ensuring oil revenues drive development. The need to set up accountability mechanisms to make transparency meaningful is therefore imperative.

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[29] See Rosser (2006) *The political economy of the resource curse: A literature survey*, DFID
[30] For fuller analysis of the divergent Indonesia-Nigeria experience see Bevan, Collier and Gunning (1999) *The Political Economy of Poverty, Equity and Growth, Nigeria and Indonesia*, Oxford University Press

5.2.Contract Transparency

Contract transparency requires that the process for licensing of oil blocks must be open and competitive, contract disclosure must be mandatory; and the product of contracts (oil production data, sales price, revenues, costs) must not be held confidential[31]. Several emerging oil producers in Africa have embarked on ambitious governance reforms particularly on improving contract governance. Sierra Leone, South Sudan and Liberia have mandatory contract disclosure requirements in their Petroleum Laws. They also have provisions for the application of an open and competitive bidding process in the award of oil concessions. Others such as Ghana and Nigeria rely on administrative fiat to publish petroleum contracts.

Either way, there is a fundamental departure from the era of wide confidentiality scope to a more progressive regime in which contract disclosure no longer exposes investments to potential risks or what is commonly called "competitive risks".

This is because, there is abundant evidence that contract disclosure does not reduce the competitiveness of an oil company because what is considered commercially sensitive secrets are often not contained in the primary contracts signed between the State and Contractors[32].

Even before first oil drops, Kenya has already set a strong foundation in the Constitution to uphold contract transparency. Article 35 of the constitution establishes the right of every Kenyan to access information when required for the exercise of a fundamental freedom. However, Kenya's PSCs have non-disclosure agreements as provided for in the industry law on petroleum exploration and production (1986), which bars any party in a petroleum contract from disclosing any information, material or not. Whilst PSCs stipulate the scale of revenues which flow to the government; the non-disclosure agreement means that there cannot be any kind of non-governmental oversight of government receipt of oil revenues. Therefore, ensuring that oil revenue contributes to socio-economic development is extremely difficult.

Box 5.1 Freedom of Information Bill

Article 35 of the Bill of Rights establishes the right of access to information for all Kenyans. Currently, the Ministry of Information, Communications and Technology is in the process of drafting legislation introducing a framework through which information held by public bodies can be accessed. The Freedom of Information Bill is progressive, and was described by one expert as "a very good bill", but despite numerous promises that it would be considered a priority, its passage has stalled.

If passed, the Bill could provide civil society groups with a powerful tool through which to hold government accountable in the oil and gas sector. The Platform should, therefore, lobby strongly for the Bill to become a government priority.

Uganda provides an example of how freedom of information laws can be used to hold government accountable in the oil and gas sector. Uganda's Constitution, like Kenya's, establishes the right of information for all citizens. This is reinforced by the country's Access to Information Act. In 2009, following extensive lobbying by parliament and civil society organisations, the Ministry of Energy agreed to grant parliament access to Tullow Oil's PSC, although not to the general public. The PSC was then reviewed by an independent expert and judged to be a good deal for the country. Kenya's Freedom of Information Bill could provide a similarly powerful tool.

[31] Adam, M.A. "Between a Blessing and a Curse – the State of Oil Governance in Ghana:, ACEP Policy Paper Series, Vol. 1., 2013.
[32] Paul Healy, Venkat Kuppuswamy & George Serafeim (2011) "What Impedes Oil and Gas Companies' Transparency"? Working Paper 12-038, Harvard Business School, November 18, 2011

The Constitution is the fundamental law of the country and is superior to the Act of 1986, but industry laws have often emboldened contractors who insist the legal frameworks governing their contracts are the industry laws and not the general laws of application. Perhaps this brings to the fore the urgent need to harmonise legal frameworks in order not to create room for oil companies to exploit the gaps.

The Constitution also supports transparency in another way. Article 71, as mentioned above, requires parliamentary ratification of any transaction which involves exploitation of Kenya's natural resources. Clearly, if the government is unwilling to disclose payments it receives from oil companies or specific details of PSCs, there can be no parliamentary scrutiny over transactions regarding natural resources. The Government's current position on transparency, may therefore be deemed, unconstitutional, and this should be used as an advocacy tool. Further, Kenya sits in direct contradiction of global transparency initiatives and is lagging behind in implementing global norms and best practices.

Kenya's model PSC also leaves a great deal to confidential negotiation with oil companies. Timeframes, development plans and profit sharing are not set out in the model PSC, meaning most stakeholders are excluded from knowing exactly how much revenue is being generated. The PSC employs a sliding scale linked to daily production targets to determine profit sharing, but otherwise specific details are kept private.

Tullow Oil has already taken steps towards publishing its payments to government in the country, and an ERHC senior manager confirmed to the author of this report that the company had no issue declaring the terms of its PSC[33]. During consultations for this report, IOCs indicated commitment to to publish payments to government, but that they could not currently do so because provisions included in the model PSC proscribed it from doing so without government permission.

The source said that it seemed there was an unwillingness to publish the terms on the part of the government because it feared losing its competitive edge in negotiations with oil companies. This fear seems misplaced. Terms in earlier contracts, prior to Kenya's first significant oil discovery, were more generous to companies owing to the greater need to encourage new contractors to develop the sector amidst high levels of risk. However, following recent finds, any company looking to enter the sector would undoubtedly expect higher terms.

Additionally, the licensing regime in Kenya does not promote transparency in the contracting process. For instance, there is neither a framework for the application of open and competitive bidding nor the disclosure of beneficial ownership information. These non-

[33] Full report available at: http://www.tullowoil.com/files/pdf/tullow_ar_report_2013.pdf

disclosures increase governance risks around petroleum contracts by strengthening the perception of "too lucrative legal benefits for firms"[34].

In the following example, South Sudan's Petroleum Act 2012, Section 79, provides a comprehensive framework for contract transparency.

Example: South Sudan

"The Minister shall make available to the public, both on the Ministry's website and by any other appropriate means to inform interested persons:

a. All key oil sector production, revenue, and expenditure data, petroleum agreements and licenses;

b. Regulations and procedures related to the petroleum sector;

c. Justification of award of petroleum agreements, the beneficial ownership information for the contractor and document proof of the requisite technical competence, sufficient experience, history of compliance and ethical conduct and financial capacity of the contractor;

d. Annual production permit;

e. Any model petroleum agreements;

f. The key parameters of each petroleum agreements to the extent such parameters differ from an already published model petroleum agreement, including the cost oil management and limits, the production sharing formulas and mechanism, any bonuses, taxes or fees, royalties, any exemptions or favourable tax treatment any stability clauses; and

g. Except for the information and data referred to in Section 76(5)[35], information relating to petroleum activities, including information on petroleum agreements and relevant treaties as prescribed in the regulations".

[34] Joseph Ayee, Tina Søreide, G. P. Shukla and Tuan Minh Le "Political Economy of the Mining Sector in Ghana", The World Bank Africa Region, Public Sector Reform and Capacity Building Unit, July 2011.

[35] Section 76(5) provides that "Information received pursuant to this section shall not be made public if such information: a. contains proprietary data belonging to the government, license of contractor; or b. must be kept confidential in order to maintain a climate of competition between the licenses and contractors participating in petroleum activities". Thus, the only information that cannot be disclosed is one that has proprietary implications.

Box 5.2 Diffusing objections to contract disclosure		
Objections		Reality
Companies	Need to protect commercially sensitive information	Most commercially sensitive information is not included in primary contracts. Plus, within the industry, most competitors are familiar with comparable contract terms, regardless of the official transparency. The perceived risk of a 'race to the bottom' is therefore unlikely.
	Contract confidentiality is a long-standing practice	Until the turn of the century, there was no incentive for companies to risk diverging from the practice of confidentiality. However, there is now a vocal global lobby advocating transparency. Weak commitment to the principles of transparency now affects companies' reputation the world over.
Governments	Contracts are too complex for the public to understand	The public, via civil society, should develop understanding as industries develop. Even in the absence of understanding though, failure to publish contracts sparks scepticism and lack of trust over the government's handling of negotiations and revenues.
	Publication risks renegotiation	Natural resources contracts are some of the most oft renegotiated contracts that governments enter into. While it may be a procedural headache, government could also stand to benefit from this process.
	Disclosure will erode bargaining power	Governments get their bargaining power from the fact that resources are finite and location-specific. This will be unchanged by the publication of contracts.

There have been calls for contract transparency to become a part of Kenya's general governance framework. For instance, Mohamed Elmi commented: "it is very hard for government to sustain its opposition to payments disclosure. The Constitution makes the right to information very clear"[36]. The World Bank has also recommended that Kenya modifies the current confidentiality provision to provide a clause for public disclosure[37]. Additionally international legal regimes by home countries has resulted in the publishing of key terms of PSCs through the Securities and Exchanges Commission (SEC)

Contract transparency also exposes rent seeking public officials and oil companies who try to capture regulators and politicians. Most of these corrupt acts have been investigated under either the US Foreign Corrupt Practices Act or the UK Bribery Act. But in most of the cases, national efforts at investigating such deals only seek to cover up for private oil companies or at worst to legitimise the deals.

[36] Research Team interview, MP for Wajir East Mohamed Elmi, Nairobi, 11 March 2014; Research Team interview, KCSPOG representative, Nairobi, 12 March 2014

[37] "Kenya sets framework to manage new petroleum wealth", *World Bank News,* 27 August 2013

To compel oil companies to eschew bribery, Ghana has become one of the first countries in the World to introduce anti-corruption clauses in petroleum contracts. It reads as follows:

"Each contractor party warrants that neither it nor any of its Affiliates or any of its subcontractors, their officers, directors or employers has made, offered, or authorised and will not make, offer, or authorise with respect to the matters which are the subject of this

Agreement, any payment, gift, promise or other advantage, whether directly or through any other person or entity, to or for the use or benefit of any public official (i.e. any person holding a legislative, administrative or judicial office, including any person employed by or acting on behalf of a public agency, a public enterprise or a public international organisation) or any political party or political party official or candidate for office, where such payment, gift, promise or advantage would violate to the extent applicable to such Party (i) the applicable laws of Ghana; (ii) the laws of the country of incorporation of such Party or such Party's ultimate parent company; (iii) the principles described in the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, signed in Paris on December 17, 1977, which entered into force on February 15, 1999, and the Convention's Commentaries; (iv) the United States of America Foreign Corrupt Practices Act 1977; and (v) the United Kingdom Bribery Act 2010."

5.3. Revenue Transparency

Revenue transparency is important for several reasons. On the supply side, it enables Governments to become accountable to their citizens in accordance with the social contract that exists between them. It also builds trust for the government, ensuring its legitimacy to manage the resources of the people as a trustee. On the demand side, it empowers citizens to track their resources, the performance of their government and the value such revenues add to the economy or community.

Revenue transparency was first built around payment disclosure pushed for under EITI standards. In fact, one of the main criticisms of EITI was its main focus on revenue transparency. This criticism influenced the new EITI standards which now require more disclosures beyond payments and receipts.

To date, many countries have adopted more comprehensive reporting standards on revenues ranging from country by country reporting to project by project level reporting. This has ensured that communities that are

Box 5.3 Ghana's accountability mechanisms in oil revenue management

- The Public Interest and Accountability Committee, established by law, independently monitors spending and provides platforms for public scrutiny.
- The finance ministry discloses payments received, down to the barrel, and provides information on revenue distribution to the various accounts, including information on oil-funded projects.
- The Bank of Ghana, which manages the petroleum funds, is required to issue semi-annual reports on the funds, available to Parliament and to the public.

directly affected by oil extraction are able to monitor and track the size of ceded revenues.

In Ghana, the government passed the Petroleum Revenue Management Act, 2011 (Act 815), requiring publication of information on receipts from petroleum companies, online and in national newspapers, four times per year. The law also requires the government to submit reports to parliament and to the public every quarter and for audited statements of Ghana's oil accounts to be made public. In addition, it establishes a Public Interest and Accountability Committee including civil society activists. Enactment of the law has been seen as a particularly progressive step towards more accountable management of the country's petroleum revenue, and the government has since been declaring its revenue from the sector.

In Alaska, the state government instituted the Permanent Fund dividend; a regular cash transfer from the petroleum fund's interest earnings to state residents. The relevance of Alaska's model of revenue distribution to the subject of transparency and accountability is borne out of the fact that government becomes more transparent and accountable for its management of the resources. When petroleum revenues are distributed among the people through direct cash transfers, they become committed to asking questions regularly about the size of revenues received by the government as well as their entitlement. Government is therefore constantly providing information to the people about production level, revenues and use of the revenues.

These examples each prove that natural resources can drive pro-poor growth if managed appropriately, but differ in their policy mechanisms. They are however all united in their commitment to transparency and accountability.

Ghana provides a useful lesson in establishing accountability mechanisms over revenue management. But Ghana is far from a perfect oil economy because the watchdog committee is starved of resources, budget transparency is poor, and infrastructure projects reportedly lack value for money. However, in principle, Kenya could benefit from establishing similar mechanisms. Much like Ghana, Kenya has the benefit of reasonably well-established institutions, like the Committee for Revenue Allocation (CRA).

5.4. Global Transparency Initiatives

Issues of resource governance have become a focal point for discussion in the transnational arena. The sophistication of global commodity markets and the role of financial actors in swaying market fundamentals calls for stronger regulation in the global trade of natural resources, so governance is no longer only a national policy issue. In this regard, Kenya's national legislation on transparency and accountability is falling behind developing global norms.

5.4.1. Voluntary standards: the Extractive Industries Transparency Initiative (EITI)

EITI compliance requires the publication of payments between companies and governments in the extractive industries (EI). Kenya is not EITI compliant, nor is it a candidate country.

Kenya's candidacy for EITI has never moved beyond initial stages. EITI's Kenya focused adviser told researcher team of this report that the country had been approached since 2006, with only limited response.[38].

The adviser said that the oil companies he had spoken to in Kenya had shown enthusiasm for the progression of Kenya's EITI application, but that the government had deep-seated sentiments against transparency. According to the adviser, the closest indication that EITI had that the government was willing to push ahead with the application was in July 2013 when Cabinet Secretary for Mining Najib Balala said on a visit to London that he would like to see Kenya join the EITI. Following his return to Kenya, Balala has made scant reference to the initiative[39].

Beyond tracking royalty payments, EITI's new transparency principles cover exploration contracts, beneficial ownership, the national oil company, and social expenditure by companies, each of which is a crucial area before oil or gas is produced.

In addition to the dividends of transparency, Kenya stands to gain from commitment to the initiative. EITI develops a country's reputation for probity, signalling to investors and international finance institutions that the country is committed to good governance.

There is nobody driving Kenya's EITI application. A brainchild of Publish What You Pay (PWYP), most EITI applications are driven on a national level by the lobbying of PWYP national coalitions, but in Kenya, this body is woefully underdeveloped. Neighbouring Tanzania's PWYP coalition has 28 members, Kenya's has but three.

Box 5.4 Nigeria Extractive Industries Transparency Initiative (NEITI)	
EITI Compliant	Since March 2011; governed by the National Stakeholders Working Group (NSWG)
Civil society	Included in the NSWG but appointed by government and carry no popular mandate Criticised for inadequate and irregular communications with their constituencies
Companies	Formally committed, but the sector is still defined by complex patterns of beneficial ownership which are not adequately accounted for in EITI reports
Governments	Ruling party faces limited accountability to the National Assembly, and the electorate; thus has little incentive to institutionalise transparency. Despite auditing receipts of oil payment at a national level, significant sums of money go missing when funds are disbursed.
Outcome	Ranked 40th of 58 on RWI's Resource Governance Index.
	Ranked 144th of 177 on TI's corruption ranking

[38] Researcher Team telephone interview, 8 April 2014
[39] Ibid.

Lessons	Transparency and accountability *within* the EITI process are essential; meaningful inclusion of civil society is paramount, with representative and coordinated interests (as in the case of Ghana) and extensive sensitisation to build trust between stakeholders (as in the case of Liberia).

However, whilst Kenya does stand to benefit from achieving EITI compliant status in terms of good governance, the programme should not be mistaken as a panacea for all the potential ills of a mismanaged oil economy. In the last five years, 43% of Africa's EITI Compliant countries have slipped down Transparency International's corruption rankings. Evidence such as this fuels the argument that EITI is a distracting box-ticking exercise, which acts as a reputational tool for governments and companies, without tackling the drivers of corruption.

The impact of EITI is dependent on implementation. If the initiative produces annual reports in the absence of public debate and scrutiny, it is unlikely to inspire accountability. If, however, EITI principles inspire genuinely open, transparent and thorough auditing, which in turn informs meaningful multi-stakeholder scrutiny, the initiative can be an invaluable tool in guaranteeing that oil revenues contribute to socio-economic development. Nigeria's experience with EITI proves that compliant status alone is insufficient, and provides useful lessons for Kenya regarding implementation of transparency principles .

5.4.2. Statutory requirements

EITI is a voluntary initiative and is often criticised for lacking teeth. However, the gradual trend towards legally-enforced transparency standards received a significant push in 2010, when the US passed the Dodd-Frank Wall Street Reform Act. Section 1504 of the Act requires that EI companies registered with the US Securities and Exchange Commission (SEC) produce annual reports detailing payments made to foreign governments (national and subnational), agencies and state-owned enterprises. The statutory disclosure covers taxes, royalties, license and acreage fees, production entitlements and bonuses, and there are no grounds for exemption.

The European Union (EU) has approved corresponding guidelines[40]; and member states now have until mid-2015 to transpose these directives into national law. The UK has committed to implementation of the directives, which will have direct implications on London Stock Exchange-listed EI companies, such as Tullow Oil and AOC. The Hong Kong Stock Exchange and the Tokyo Stock Exchange are also expected to follow suit, drawing yet more companies into legal stipulations that they must publish what they pay.

In the absence of EITI compliance, international legislation is the sole mechanism for ensuring citizens can track governments' oil receipts. Campaigners celebrate these developments because they empower citizens to hold their governments to account and ensure oil revenues drive development. Without domestic legislation, however, the

[40] EU Accounting Directive (2013/34/EU) Chapter 10, and, EU Transparency Directive (Article 6, 2013/50EU)

developments will not benefit oil-producing countries universally. Further, company-level disclosures in a system characterised by secrecy is limited; citizens will know how much Kenya receives, but will not know how the funds are spent. The development of these international laws provides the Platform with a powerful advocacy tool to challenge the government's argument that publication of payments and PSA terms weakens competitive advantage, particularly as a US court has ruled in favour of transparency on the matter

SECTION 6

LOCAL CONTENT

Photo courtesy of www.businessweekly.com

6.1. Local Content – Policy, Regulatory and Implementation Challenges

Legislated local content provisions are becoming commonplace in oil and gas regulation across developing economies. Such provisions aim to add value by creating jobs, developing skills and fostering development of local business, ensuring that a country's oil and gas industry contributes broadly to the national economy, rather than simply in terms of revenue.

Local content has often been expressed in terms of national content, that is, the composite quantum of national goods and services used by foreign oil and service companies.

Some countries have developed specific laws and/or regulations to implement local content. Nigeria for example passed the Nigerian Content Act 2010. Ghana also passed its Petroleum (Local Content and Local Participation) Regulations (LI2204), detailing minimum requirements for local employment, as well as use of local expertise, goods and services and company ownership, in its oil and gas sector.

Kenya's Model PSC as contained in the Petroleum (Exploration and Production) Act of 1986 contains two clauses on the issue, requiring that, "*the contractor, where possible, shall employ Kenyan citizens in petroleum operations, alongside training those citizens,*" (s.13.1) and providing for, "*a contribution on the part of the contractor for a negotiable sum to be contributed to the Ministry's training fund*" (s.13.3). These provisions may be changed when the Petroleum Act is updated.

That said, Kenya's National Energy Policy, not yet enacted, recognises "*the need to develop local talent and capacity in energy resource exploitation and infrastructure development. It is also important that the opportunity is availed for provision of services and goods by locals in the exploitation of natural resources and infrastructure development.*" (s.9.1.2.5). Development of local content regulation is a work in progress, and the Policy envisages this evolving over the medium-term (to 2023) and long-term (to 2030).

The new Petroleum Exploration, Development and Production Bill 2014 also provides for local content albeit with a limited scope. It provides that:

i. Oil Contractors must prepare and submit local content plans for approval by the proposed National Upstream Petroleum Authority.

ii. There shall be a Training Fund to be used to provide training to citizens;

iii. First preference will be given to the Counties in the use of services and the country in the use of goods.

The Local content provisions are however skeletal and leave out important components that make local content a strategic tool for facilitating the integration of the oil sector with the non-oil sector of the economy.

The Bill however assures that the Cabinet Secretary will be required to develop regulations on local content. This is quite challenging and experience elsewhere shows that such regulations are often delayed whilst oil investments are being made. Ghana for instance delayed the development of local content regulations for three years and as a result lost significant opportunities during the development phase of the Jubilee project. Therefore, there was no value to the Ghanaian economy from the US$4 billion project. Materials and equipment used were imported, manufactured abroad and shipped in by foreign ships. Local equity share was lower, and to date, there is no local equity in the entire Jubilee Block because Tullow Oil and PetroSA acquired the local interests EO Group and Sabre Oil and Gas Holding Ltd respectively.

During consultations for this report, several representatives of civil society organisations advocated the need to establish clear and detailed stipulations regarding local content, as have been implemented elsewhere. One civil society representative likened Kenya's provisions on the issue to a "*moving target*", criticising the way in which employment issues were left to the discretion of oil companies[41].

Hon. Mohamed Elmi suggested that the lack of detailed provisions on the issue actually causes problems for oil companies: "*One of the main problems for Tullow is there is no information about how many people to employ from Turkana – expectations must be clear*," he said[42].

Complaints regarding employment constitute a primary catalyst for conflict in exploration regions, as local protests in Turkana in October 2013 demonstrated.

In response to the protests, Tullow Oil and its partner and the government drew up a memorandum of understanding (MoU) agreeing to work together to resolve issues that had caused the protests as quickly as possible in order to avoid a declaration of force majeure. The MoU remains unpublished. However, a leaked document details Tullow Oil's pledges; to provide government with a breakdown of its employment and utilisation of goods and services, to agree on a formal grievance resolution procedure, to commit to a doubling of social investment budget for 2014 to US$2 million, from US$1 million in 2013, and to ensure that Tullow Oil refines its local content programme[43].

Tullow Oil has also subsequently published a Report on its local content programme detailing levels of employment by level of skills and by locality of employees (see Table 3 below).

[41] Research Team interview, KCSPOG member, Nairobi, 12 March 2014
[42] Research Team interview, Nairobi, 11 March 2014
[43] Available at http://s3.documentcloud.org/documents/900069/oil-mou.pdf (The provisions of this document are consistent with stakeholders' understandings)

Table 3. Tullow Oil Workforce and Local Content Compliance in Kenya

SUB-CONTRACTORS EMPLOYED THROUGH TULLOW'S SUPPLY CHAIN (as of 31 December 2013)

			Kenyan Nationals				
Contractor	Level	Expat	Non-Turkana	Turkana	% Expats in total workforce	% Nationals in total workforce	% Turkanas in total workforce
All contractors	Director	1	4	0	20%	80%	0%
	Management	53	18	2	73%	27%	3%
	Skilled	201	476	217	22%	78%	24%
	Semi-skilled	18	92	380	4%	96%	78%
	Unskilled	12	4	677	2%	98%	98%
Total		**285**	**594**	**1276**	**13%**	**87%**	**59%**

The figures above do not include Tullow employees

Source: Tullow Kenya Profile "*Tullow in Kenya*", 2013.

The report shows that by the end of 2013, Tullow's total workforce stood at 2155, of which only 285 personnel, about 13%, were expatriates. The rest 1,870 were Kenyan citizens. Also, Turkanas in the total workforce stood at almost 60%.

In this same report, Tullow Oil disclosed that in addition to spending the Ksh.4.1 billion on local suppliers in 2013 (2012: Ksh.S2.4 billion), its contractors also spent Ksh.4.1 billion on Kenyan businesses in 2013, Ksh. 259 million of which was on Turkana businesses[44].

These figures demonstrate Tullow's commitment to the fulfilment of the terms in the MoU but whether there is a mechanism to verify the figures remains a big question. Thus, the necessity for developing a comprehensive local content law or regulations with targets and compliance measurements cannot be over-emphasised.

However, it must be stated that some have described the MoU as being a quick fix. For one thing, the document provides for "*a forum of state officers and key opinion leaders in Lodwar to garner broad-based support for the resumption of operations".* Civil society organisations were not consulted during the drafting of the MoU, so there is little oversight into how opinion leaders are chosen. In addition, without publishing the document, and in the absence of clear and detailed stipulations regarding local employment, the MoU leaves a great deal to government and company discretion.

[44] Kenya Profile "Tullow In Kenya" available at:

http://www.tullowoil.com/files/pdf/reports/Tullow_cr_2013_Kenya.pdf

Civil society representatives remain aware of the dangers of legislating for too much too quickly. Too stringent regulations, which do not reflect services and labour pool constraints, will not be useful for sector development. For example, the exploration stage requires more skilled labour than the production stage. This must be accounted for.

In Ghana, companies have struggled to find local staff because education levels lagged behind local content laws. In Nigeria, local content laws regarding company ownership fostered the emergence of hollow companies, fronted by locals, but actually owned by foreign interests.

The capacity challenge of local content could be addressed through a programme targeting skills training for young people who are either absorbed by oil and service companies or by other industries. The example in Ghana where the Jubilee Partners, with Tullow Oil as the Operator, set up a US$15 million training centre for this purpose could be replicated in Kenya (see picture below).

Figure 1: Jubilee Technical Training Centre in Takoradi, Ghana.

However, there is a need for detailed requirements to be drawn up so that companies' employment practices and use of local services can be scrutinised. During consultations for this report, one civil society representative argued for an ascending scale, detailing certain stipulations for the first three years after a contract is signed, after which local content levels would be increased, on the assumption that companies are undertaking their own training of local people[45].

[45] Research Team interview, KCSPOG member, Nairobi, 12 March 2014

This suggestion is compatible with examples of local content laws elsewhere and would complement education programmes provided by oil companies. Tullow Oil and AOC, for example, have established a polytechnic in Lodwar to provide local training. AOC envisages that the facility would require investment of between US$5m and US$6m in the long run[46].

However, in order to avoid a gap between law and its implementation, local content stipulations need to take into account constraints in local industries and labour pools. In order to achieve this, the government should undertake a study mapping local capacity and incorporating considerations for future development of capacity. In this, both oil companies and civil society should be encouraged to contribute in order to develop as full a picture as possible.

However, it is also important that legislation takes into account complex employment issues often confronting oil companies on the ground. For example, the AOC manager said that during the building of a road to its Sala platform in the north-eastern corner of Block 9, it had to change construction teams three times during a 150km section of the road because it passed through territory of three different tribes[47].

Advocacy on local content should highlight Kenyan legislative shortcomings regarding local content in comparison with other jurisdictions whose oil industries are in a similarly young state. In this regard, Ghana provides a pertinent example. The country's Petroleum (Local Content and Local Participation) Regulations (LI2204), referred to above, provides extensive stipulations aimed at guaranteeing oil wealth trickles down through local employment, use of local services and companies, as well as use of local banks.

6.2. Local content; politically contentious

Weeks before the passage of Ghana's local content law the cabinet was approving deals that did not apply and the influence of powerful trade unions, ministerial politicking and significant vested interests have all blighted the passage and implementation of Gabon's local content laws.

The passage of local content laws in Kenya is likely to prove no less political. As outlined above, issues of local employment have already sparked local protests, forcing IOCs to halt operations in Turkana in October 2013.

Also, the granting of excessive discretionary powers in local content frameworks empowers political heads to vary local content requirements to the advantage of friendly companies. In addition, discretionary powers could be used to impose "shadow" companies on petroleum licenses in the name of meeting local content requirements.

[46] Research Team telephone interview, AOC senior manager, 27 February 2014

[47] Ibid.

Local content could provide a bargaining chip for politicians to seek rent and to secure their interest in the oil and gas business. Mushrooming of local oil companies often backed by powerful politicians are imposed on foreign companies as conditions for awarding oil blocks. These local companies often do not have financial and technical capacity. They are carried over by the foreign companies and eventually reap benefits they do not deserve. In a recent Petroleum Agreement signed in Ghana between the Government of Ghana and Heritage Oil, there was a clear statement by Heritage Oil to the effect that it would guarantee the performance of the local Ghanaian company BlueStar which holds as much as 38% in the concession. It is curious how a company with such a significant stake has to be carried over by Heritage Oil. Who are the owners of the local company and what value does the company bring to the contract area?

The increasing level of farm-in transactions involving small companies must also be reviewed. Local companies that are granted exploration rights are only being speculative. A few years after securing an exploration right, they farm-out part of their stake to foreign oil companies and make money without any exploration effort. Such practices have led to most potentially lucrative oil blocks usually in relinquished areas being awarded to local firms which make millions of dollars at no significant cost to them.

It is therefore important to note that whilst local content seeks to integrate the oil and non-oil sectors, it could also provide a convenient stage for corruption if there are no appropriate safeguards. This is why in some countries, fronting by a local firm for a local owner or foreign owner has been criminalised. There are other global safeguards such as the US Foreign Corrupt Practices Act and the UK Bribery Act under which corrupt deals involving US and UK companies on a foreign land can be investigated and punished.

SECTION 7

LAND AND ENVIRONMENTAL RIGHTS

Photo by Boniface Mwangi

7.1. Land Rights

7.1.1. Oil Industry and Land Needs

Land issues are extremely potent in Africa, and Kenya is no exception. Manoeuvring communal land rights, derived from customary ownership principles, into formalised structures of land tenure has proved a source of conflict between indigenous populations, national governments, and foreign developers. Introducing lucrative oil into this equation compounds already difficult issues.

In Kenya, the challenge of adequately protecting land rights is complicated by the fact that some 66% of the country's land mass is customary land, which includes much of the land in the north that hosts oil and gas exploration.

Kenya has proved progressive in recent years by committing to institutionalised customary land rights, but these structures and policies are in their infancy, and their ability to negotiate citizens' entitlements with oil-hungry developers and revenue-hungry authorities is yet to be tested.

The burden that the oil and gas sector places on the environment risks further complications, and intensifies the threat of disputes. While the oil industry is now acutely aware of its environmental impact, thanks largely to international advocacy by Greenpeace and others, it remains a highly pertinent issue for new producer states to guarantee that global standards are upheld.

Currently, oil installations in Kenya, still at the exploration stage, are limited in scale. During consultations for this report, several explorers made the point that the idea of huge swathes of land being taken over by the oil industry is simply a misconception. The average size of an exploration platform is 200x200m, perhaps accompanied by a 500m-broad no-entry zone around the perimeter and a 400x800m airstrip[48].

However, as the sector grows, so too will the amount of land required. In February 2014, the MEP announced its intentions to invite international bids for the design and construction of a crude oil pipeline linking the oil fields in Turkana to the planned port of Lamu[49], which forms a crucial component of the LAPSSET corridor. The pipeline is in the pre-development phase, but the ministry has targeted a completion date of November 2016. Further, as mega projects like the pipeline

Box 7.1 Conflict in Isiolo County

In Isiolo County there are historical and socio-political dimensions to the land conflict, in which ethnic groups fight over scarce resources. Violent banditry and cattle-rustling have long plagued pastoralist areas.

However, Isiolo town's planned 'Resort', which forms part of the government's Vision 2030 flagship LAPSSET project, adds a new dimension. Rising land prices have exacerbated long-standing disputes and fanned ethnic tensions.

Further, a dispute has emerged between local leaders of Isiolo county and Meru county over land boundaries, as both authorities scramble to benefit from the LAPSSET developments.

[48] Research Team interview, corporate affairs officer at IOC, Nairobi, 11 March 2014
[49] "Uganda signs development accord as East African Oil Industry builds momentum", *African Energy*, 271, 13 February 2014

take shape, corresponding infrastructure developments will emerge. Lake Turkana is already, for example, the site of a DFI-financed road project[50], and, as Kenya's oil industry moves from exploration to production, infrastructure will become more land intensive.

Based on past experiences of large infrastructure projects in Africa, the completion dates of these projects are probably ambitious. Nevertheless, given the pace at which legislation moves, and the requisite consultation process, it is necessary to ensure the land regime is in place well before construction begins. The conflict in Isiolo County exemplifies the potential problems if land issues are ill-addressed

7.1.2. Legislated land rights

The 2010 decision by the African Commission on Human and People's Rights in the Endorois case guarantees indigenous communities' right to land[51]. Kenya's legal regime surrounding land issues is in a state of transition and as it stands, the legislation is incomplete. A key provision of the Constitution is the re-registration of all land, including community land. However, the Community Land Bill, designed to provide substantive provisions for facilitating re-registration, is yet to be passed.

The Bill, which replaces the Trust Land Act 2009, creates Community Land Management Committees, which are tasked with the administration and management of the land. The Land Development and Governance Institute, who conducted a technical audit of the Bill, took issue with the extent to which these legalised institutions satisfy the constitutionally-guaranteed communal ownership principle[52]. Nevertheless, the new committees, which echo Botswana's Land Boards, in principle provide for legislated community rights and institutionalise customary entitlements.

The fact that the committees have not yet been created, and the Bill not yet enacted, is important. A leading African land law expert described the delay as *"ominous"*[53]. Oil exploration is currently taking place on land which is not legislated for. This presents two direct issues:

There is no legislation in place by which communities can seek compensation; In the event of a problem—loss of grazing land due to an oil spill, for example—there is no clarity over who would be entitled to compensation, because there is no clarity over who owns the land. The vacuum of rights that emanates from stalled legislation is therefore an urgent issue.

[50] "Dutch grant for Lake Turkana road", *African Energy*, 265, 8 November 2013
[51] For more information, see "Landmark ruling on indigenous land rights", *Human Rights Watch*, 4 February 2010
[52] "Technical review of Community Land Bill", *Land Development & Governance Institute*, 14 January 2014
[53] Research Team telephone interview, London, 24 February 2014

7.1.3. Sub-surface rights: eminent domain

The issue of eminent domain has defined the relationship between mineral rights and surface rights. Of specific concern to the oil and gas industry, the Community Land Bill only concerns surface rights. It does not extend to what is below the ground, and petroleum rights are vested in the government[54]. The Community Land Bill sets out that "*no right on community land may be expropriated or confiscated, save by law in the public interest and consideration of payment in full, of just compensation to the person or persons"* (s.7.2).

The main issue surrounding the principle of eminent domain is its implementation. Firstly, under what circumstances can the government expropriate land, and secondly, how much, when, to whom must compensation be paid?

Box 7. 2 Overview of land legislation

- The Constitution guarantees "(a) equitable access to land; (b) security of land rights; (c) sustainable and productive management of land resources" (s.60.1). It also grants the government the authority to requisite land if it is in the interests of the public good (s.40.3.b).
- The Energy Bill vests ownership of petroleum reserves to the state (s.133).
- The Land Act 2012, Land Registration Act 2012 and National Land Commission Act 2012 legislate the regulation of all land.
- The Community Land Bill, in its current format, recognises community land rights and provides powers to country governments for its administration

The presumption that oil and gas exploration is in the public interest, and therefore the government has the right to expropriate requisite land for its operations, is typical. However, in Kenya, there are limited checks and balances over the government's authority to exercise this right. Constitutionally, the National Land Commission can make recommendations to the appropriate authorities related to land and the use of natural resources (s.67.2.d) but these recommendations are not binding.

In instances of expropriation, the Bill provides for a "*(a) an environmental, social, cultural and economic impact assessment; (b) continuous monitoring and evaluation; (c) payment of royalties to the community; (d) requirement for the investor to build capacity and transfer technology to the community"* (s.53). These provisions are progressive, however, the practical undertakings and procedural stipulations are comparatively weak, which makes for difficult implementation of the broad principles. The issues, which are elsewhere on the continent addressed in petroleum laws, are ill-addressed within Kenya's current legal regime.

[54] According to s.62.1.f of the Constitution, and s133 of the Energy Bill

The second issue, the compensation question[55], is similarly speculative. While the Constitution, Energy Bill and Community Land Bill all make reference to the necessity of compensation in instances of enforced land acquisition, the legal regime is vague on the specifics. Kenya is not unusual in this regard, and there have been multiple instances where land has been woefully undervalued so as to offer low compensation[56]. According to the National Energy Policy, compensation will be determined by a registered land valuer.

Box 7.3 Procedural stipulations on the state's right to acquire land for petrol operations		
Strategy	Elsewhere	In Kenya
Regulating where operations can be installed	Petroleum laws in Liberia and Uganda, for example, stipulate that operations cannot be developed on land within 200m of occupied buildings, 50m from cultural reserves, or 5m of agricultural crops.	Kenyan law makes no such provisions.
Providing land owners with warning	Petroleum laws in Ghana, for example, stipulate that the minister must provide written notification of a pending license to the landholder, chief and local government a minimum of 45 days prior to allocating the license.	Kenyan law states that contractors must offer landholders 48-hour notice before entering the land.
Compensation prior to the acquisition	Typically, compensation is guaranteed prior to the start of construction.	Kenyan law makes no such provisions.

The Natural Resource Management Project, funded by the World Bank and completed in 2006, includes a Resettlement Policy Framework, designed to meet the needs of local people in instances of involuntary physical or economic displacements. To date, the policy and its related Resettlement Action Plans (RAPs) have held greatest relevance for the land-intensive power sector. However, as the oil industry progresses and related infrastructure expands, ensuring these principles apply will become essential.

The nascent oil industry can learn from the experience of the Kenyan power sector, by undertaking RAPs and other initiatives that favour equitable land management.

[55] It is important to note that compensation paid at the start of development for the acquisition of land, is different to the compensation owed in the event of damages inflicted. The latter, according to the model PSC, is the sole responsibility of the contractors.

[56] See, for example, Nzekwu v Attorney-General East-Central State (1972)

7.1.4 Gender Dimensions of Land

The development of the oil sector may lead to a loss of a land which may mean that women are faced with additional challenges for example it may mean that women have to go farther to collect firewood and water, as they are traditionally the members of community who carry out these tasks.

As the current onshore oil finds in Kenya are in the arid and semi-arid lands, the loss of agricultural land is not likely to be a big problem. However, the loss of land may lead to relocations with women bearing the bulk of the burden to resettle families.

This occurs in a context of patriarchy where women do not have a seat on the negotiation table when compensation is being discussed. Left out of these negotiations and no guarantee that the male members of the family shall share any compensation received.

7.2. Environmental Rights

Environmental issues are so important that they now reside in the transnational domain and a wealth of guidelines on industry best practice has emerged. Conforming to conceptions of international best practice, the protection of Kenya's environment is governed by the Environmental Management and Coordination Act (EMCA) of 1999.

The EMCA is broadly considered robust. However, it was enacted prior to significant oil and gas developments.

Reconsidering the EMCA in this context concludes that Kenya's legal regime is strong, but its enforcement has often been weak.

Article 42 of the Constitution, guarantees all Kenyans the right to "a clean and healthy environment, which includes the rights to have the environment protected for the benefit of present and future generations through legislative and other measures", as well as Article 69 (1) a, which reads, "The State shall ensure sustainable exploitation, utilisation, management and conservation of the environment and natural resources, and ensure the equitable sharing of accruing benefits," provide useful advocacy tools for better enforcement of the EMCA.

As per the EMCA, the central mechanism used to enforce environmental safeguards are environmental impact assessments (EIAs), which are required by any company wishing to launch a project that has significant environmental impacts.

The EIAs are to be submitted to the National Environment Management Authority (NEMA) before the project begins, in line with the Environment (Impact and Assessment) Regulations 2003.

7.2.1. Implementation of environmental rights

As mentioned, NEMA is tasked with enforcing the provisions of EIA reports, and if a company breaks such terms, it can bring all activities to a halt by terminating the licence. As priority projects of high importance, oil industry projects are managed centrally by NEMA in Nairobi.

The source at the Kenyan environmental-protection organisation queried the extent to which NEMA followed up on implementation of its recommendations[57]. Two oil companies reported that NEMA had not visited their sites. One executive commented that the onus was on IOCs to provide evidence to NEMA that they are compliant[58].

NEMA says it does try to follow up, but according to a director: *"The reality of the matter is that NEMA does not have adequate resources. In many areas, there is only one person*". It is hoping that, with World Bank support, it can build capacity[59].

In addition to the enforcement of the EIA, the content of the report itself is vulnerable to conflicts of interest. A member of a leading East African environmental lobby group raised the issue that oil companies must select third party consultants to compile the report from a list of NEMA-licensed experts. *"Given that the oil company is paying the consultants, there is considerable room for pressure to be put on the consultants who are providing the service. If the consultants identify significant environmental concerns, the costs of the project will rise, thus it is in everyone's interests to ensure there aren't any"*[60].

This risk is heightened by the scale of political connections in the industry. The source from the prominent Kenyan environmental-protection organisation said *"companies with strong political connections find it easier to obtain EIA licenses, and political pressure makes it difficult for NEMA to revoke licenses in the event of a breach"*[61].

7.2.2. Oil Spills and Gas Flaring

Oil spills and gas flaring are common features of the oil and gas industry in most oil producing countries. Effective mechanisms for addressing oil spills on water and land remain a serious challenge to the industry. Even countries with a zero gas flaring policy have not escaped from the effects of flaring because often there is no elaborate programme for the utilisation of associated gas.

Through spills and gas flaring, the environment and water bodies are polluted. Gas flaring has harmful effects on land and water—civil society should campaign for zero-flaring policy.

Oil companies have been required in most cases to set up Oil Spill Response Funds, and Emergency Preparedness Plans to provide security against spills or accidents. In most petroleum legislations, the scope of liability to pollution or damage from oil operations is

[57] Research Team interview, Nairobi, 11 March 2014
[58] Research Team interviews, Nairobi, 11 & 13 March 2014
[59] Research Team telephone interview, 10 April 2014
[60] Research Team interview, Nairobi, 11 March 2014
[61] Ibid.

also clearly defined with the view to putting responsibility on oil companies to adopt mechanism that prevent spills. The liability is based on either the "polluter pay principle" or "exclusive liability principle".

The environmental effects of oil spills and gas flaring could be damaging to communities near oil extraction and this could put communities in conflict with oil companies who are often accused of destroying the environment. This has the potential of disrupting oil operations.

Again, spills and flaring of gas adversely affect livelihoods. Especially in offshore operations, polluted water could be harmful to human health through fish or other marine food. Therefore communities who rely on fishing as their main occupation face the danger of losing their livelihoods under such circumstances. In Kenya, oil operations in the Lamu area could be vulnerable to these problems if appropriate safeguards are not put in place.

Both the state and oil companies are at the risk of losing substantial revenues during oil spills as a result of committing large amount of resources to compensate affected communities. Compensation against damage or pollution from spills could run into several millions of dollars in a lifetime. This is why a "preventive policy" is preferred to a "response policy".

It is important to mention however that, Kenya's environmental laws and regulations have not been updated yet to address oil-related environmental challenges. Also, Kenya's environmental institutions have limited capacity to deal with both onshore and offshore oil waste and other environmental hazards. The capacity challenge ranges from training deficits to logistics constraints.

7.3. Addressing Community Concerns

7.3.1. Community Engagement

The only way to mitigate land and environmental risks, is to ensure that local community groups participate meaningfully in investment decisions and project development via the implementation of well-thought out community engagement processes.

Oil companies stress the need to obtain community support for their operations. Protests in Turkana discussed above demonstrate the dangers of inadequately incorporating community voices in operations.

As the IOC officials put it: "*We are not doing it through a sense of altruism but because it is crucial to operating in the country. It provides us with a social licence to operate. There are a wide range of stakeholders, and they all have to have a role to play if we want this to work in Kenya*"[62].

These sentiments were echoed by Tullow Oil chairman Simon Thompson: "*From our perspective consent isn't really enough, we actually need the support of the local*

[62] Research Team telephone interview, 27 February 2014

community", speaking at the Brookings Institute's conference on *East Africa's oil and gas boom – promise or peril event*, held in March 2013 in Washington.

Yet companies are the first to concede community engagement processes in the country are imperfect. Owing to the fact that they are at the most advanced stage of development, the Tullow Oil /AOC process is the most advanced. Both companies have employed large community liaison departments.

AOC engages with local communities through *Barazas*, Swahili for community meetings, and *Kamatis*, Swahili for committee, which represents the local community. Through these local institutions the company aims at constant engagement, explaining what it is doing to communities at *Barazas* and using *Kamatis* to provide any updates, such as changes to timeframes[63].

Tullow Oil posts community liaison officers (CLOs), who speak the local dialect, on the ground to represent the company. These handle most community engagements and pinpoint key stakeholders at different political levels[64].

These structures are relatively well set up to work to diminish inflated local expectations. By communicating with community leaders through *Kamatis* or through CLOs, companies can facilitate the trickle-down of reliable information about oil project developments through all levels of society.

These structures also aim to incorporate community voices in investment decision-making. AOC uses *Kamatis* to manage its local tendering processes in a way which is sensitive to local community interests, as well as to draw up budget plans and proposals for CSR projects, although no money actually goes through the *Kamatis*. Similarly, Tullow Oil uses its CLOs to obtain community input in drawing up CSR budgets and programmes.

However, in terms of encouraging meaningful participation in investment decisions, these processes are incomplete. There are no mechanisms in place through which civil society can verify that community suggestions and complaints are incorporated into oil company plans.

Community consultations are an important way of managing community expectations so it is vital for both the private sector and for government to make sure that women are involved in these discussions.

In this regard, companies like AOC and Tullow Oil are not necessarily behind the curve. Oxfam America's Community Consent Index[65] has only five companies out of a representative sample of 28 in the extractives sector which have met the 'gold standard' of committing to FPIC in their engagement with local communities. Only one of these, Talisman Energy, is an oil company. According to the index report, several other companies

[63] Ibid.
[64] Research Team interview, Tullow Oil community engagement officer, Nairobi, 13 March 2014
[65] "Community Consent Index: Oil, Gas and Mining Company Public Positions on Free, Prior and Informed Consent (FPIC), Voss M and Greenspan E (eds). *Oxfam America,* 2012, www.oxfamamerica.org/publications/community-consent-index

incorporate a commitment to community consent and achieving a social licence to operate in their rhetoric, but provide scant details of what these terms actually mean, and how exactly they are to be achieved.

7.3.2. Corporate Social Responsibility

Developing in parallel with these emerging dynamics is the danger that oil companies, through their corporate social responsibility (CSR) programmes, take over where central government has been absent for decades. This can have some positive impacts—companies tend to talk up their CSR initiatives to show their positive impact on a region—but there is also some downside. CSR-driven beneficence threatens to foster a dependency on company hand-outs among local communities.

In addition, by taking a lead role in implementing developmental projects, as well as in providing basic local services that would normally be supplied by the state, CSR programmes may undermine county governments' ability to provide for the citizens they in theory represent.

CSR programmes are common practice all over the world. However, in rural parts of Kenya, their inclusion in IOC operations is made all the more vital by the absence of the state. During consultations for this report, oil companies were at pains to point out that regularly, they had little choice but to step in where the state is absent. Two prominent examples stand out:

IOC officials pointed to provision of water in Turkana, a region suffering heavily from water scarcity, as an example.", The company currently hauls vast quantities of water to its operations site, which it then stores in large tanks for community use. This solution is not sustainable, but with the government absent in terms of water provision, communities rely on Tullow Oil for water[66].

Similarly, according to the IOC officials, both it and Tullow Oil pledged US$1m to combat drought in Turkana at the request of the county governor. In this case, the company had little choice but to step in[67]. Oil companies are quick to point out that in such cases, they are fulfilling a government role which goes above and beyond their requirements in the country.

CSR policies have been criticised for de-legitimising the state. This is perhaps a little strong given that in many cases, the state is almost absent anyway, and CSR programmes often fulfil vital emergency requirements.

However, two negative consequences could emerge from oil companies' replacement of the state. First of all, there is a danger that local reliance on CSR programmes can cause local communities to become dependent on oil companies. There is already some evidence of this. In turn, this could undermine capacity development in Kenya's county governments. The purpose of devolution was to strengthen local government institutions, making them better able to provide for those they are supposed to represent. County governments are at

[66]Research Team telephone interview,, 17 April 2014
[67] Research Team telephone interview, , 27 March 2014

an early stage of their development, yet if oil companies take too much of a lead in terms of development projects, local government will be slow to strengthen capacity.

7.3.3. Managing Expectations

Inflated expectations have played a lead role in fomenting conflict in oil producing regions. There have been a few signs of this happening in Kenya.

In October 2013, Tullow Oil and AOC halted their operations in Blocks 10BB and 13T, and were forced to evacuate staff, following local protests over employment. These were led by the Member of Parliament (MP) for Turkana South, James Lomenen. Discussing these events, a senior manager at AOC told an author of this report: "*the biggest problem is expectations. How can they be managed?*"[68].

Aside from unrealistic expectations regarding immediate oil revenue, local demand for companies to employ large amounts of local labour also causes problems. The senior manager at AOC said expectations about employment far outstrip the actual number of jobs that companies are able to create. "*There may be job numbers in the thousands, not commercial well engineers, but pipefitters, welders and mud-samplers requiring technical qualifications, rather than professional qualifications. The oil and gas industry cannot be the game changer in the country's north. At best, it can be the stimulus,*" he added[69].

The influx of expensive equipment, such as trucks and aeroplanes, combined with the arrival of foreigners and Kenyans from elsewhere, exacerbates the perception that communities are being excluded from oil wealth.

Box 7.4 The problem of weak institutions; case study of the Niger Delta

The seemingly implacable and intractable Niger Delta crisis is rooted in the underdevelopment of the region. Weak local institutions in the Niger Delta and imbalances between federal/local authorities explain, in part, why the region's development has been stifled, despite the volume of oil trade. Local government arrangements have changed on multiple occasions in the last 50 years, with the creation of new states and the introduction of Local Government Authorities (LGA).

Nigeria's revenue allocation formula is often criticised for its imbalance, but even the revenue that does make it through to local government has been ill-managed. LGAs and state authorities, who typically derive their authority from patronage and clientelism, have been unable to effectively spend the sums they receive. Plus, they lack transparency in their budgetary allocations, and 'development' projects tend to benefit local 'elites' at the expense of the needs of the community.

The Niger Delta Development Commission was set up in 2000 to address these issues, but the same problems – corruption, low technical capacity, and lack of accountability to the citizenry – simply transferred to a new institution.

Poverty-stricken communities and weak local governance make for difficult operating environments for IOCs. Companies lament that the failings of local government mean they are often called upon to provide basic services to their host communities. Companies' role in basic service provision is much-criticised, because they lack the development expertise to do so successfully, and because their involvement weakens citizen relationships with local government.

In these circumstances, teething problems relating to the country's adaptation to the new constitution can trigger conflict. A civil

[68] Research Team telephone interview, 27 February 2014
[69] Ibid.

society representative who is focused on conflict prevention in Kenya's arid and semi-arid lands observed that IOCs must now deal with two government agents: a county governor and the MP for the relevant constituency. Both have competing – and equally valid – claims to the local community, and often conflicting interests of their own. The protests against Tullow Oil and AOC were led by local MP's and at least in part were a consequence of competing interests[70].

IOCs interviewed for this report insisted that they take strong precautions to engage with local communities on a broad-based level—to avoid speaking only with local chiefs or politicians.

They argue that such an approach has the disadvantage of missing out "*the middle tier*", as one civil society representative put it[71]. While collaborating only with these "middle tier" politicians and community leaders might not be the best way to engage with the entire community—particularly as they often have personal business interests at stake—they are important community leaders who people turn to for strength against the encroachment of alien companies. Their neglect is a certain trigger for conflict.

If steps are not taken now to address issues of inflated expectations, the situation will only get worse as oil and gas-related infrastructure expands across the region.

According to the conflict prevention-focused civil society source, a worrying dynamic is emerging: local communities have realised that if they can push a company a little, for example by protesting, the company will give in, rather than shut down production[72].

One civil society representative suggested, oil company communication, "*should not be confined to the county executive, but should go through the county assembly*".[73] This is compatible with the constitution, which provides that the "*county assembly may receive and approve plans and policies for […] the management and exploration of the country's resources*".[74]

There are indications that county assemblies might take a lead in oversight of oil company and community engagement processes. Following Tullow Oil and the government's signing of an MoU agreeing to take steps to resolve issues which caused the protests of October 2013 (see below, section 4.e, Local Content), 30 ward representatives from Turkana County criticised the agreement, saying they would table a bill before the county assembly to obtain a deal which better reflected local interests[75]

[70] Research Team interview, representative from international NGO focused on conflict prevention, Nairobi, 14 March 2014
[71] Ibid.
[72] Ibid.
[73] Research Team interview, representative from international NGO focused on conflict prevention, Nairobi, 14 March 2014
[74] See Constitution, pp. 113, s.185(4.a)
[75] "County ward rep dismiss deal between Tullow Oil and Government", *The Standard,* 14 January 2014