

AFRICA RISK CONSULTING

Country briefing – Kenya

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1 Summary

The oil sector remains cautious despite International Monetary Fund projections that commercial oil production will begin in six to seven years. Oil sector executives cite inexperience of new minister and uncertainty around new petroleum act. Oil Industry Supply Coordination Committee (SupplyCor) threatens boycott of region's only oil refinery beginning in June due to inefficiencies. President Uhuru Kenyatta announces technocratic government with substantial private sector experience. Violence increases across Kenya, politically motivated in the Northeastern province and criminally motivated in Nairobi and Western province.

2 Business dynamics

2.1 Oil sector is cautious despite optimism of International Monetary Fund

Recent discoveries in onshore drilling for oil have moved **Kenya** closer to commercially recoverable quantities. An **International Monetary Fund (IMF)** report in April 2013 described recent discoveries in **Turkana** district in the north west of Kenya's **Rift Valley** province as "commercial", a term that the Kenyan government and the exploration firms have tended to use sparingly to temper public expectations¹. The report projects that Kenya will start producing oil in six to seven years. In February, **Tullow Oil** published reports suggesting that it had achieved "potentially commercial" flow rates of oil in its **Twiga South-1** well. Tullow itself admits that considerably more exploration and appraisal will be needed to determine whether commercial thresholds have been met. The oil sector as a whole remains cautious.

"Oil companies in East Africa are looking for TLC, transparency, longevity and certainty. There was uncertainty before the election about these, and there is uncertainty now. With regard to Kenya, the jury is still out."²

Sources of uncertainty include the appointment of the new technocratic minister, **Davis Chirchir**. A former commissioner at the independent electoral commission, Chirchir was general manager at the **Kenya Posts and**

¹ IMF Country Report 13/107, April 2013

² Source, senior oil executive

Telecommunications Corporation (KPTC) but has no oil sector experience. He is a close confidante of vice president, **William Ruto** and has the ear of president **Uhuru Kenyatta**³. There are rumours that he "*may be better at looking after the interests of those in power, rather than the oil sector*"⁴. There are no suggestions about who will be Chirchir's permanent secretary. This appointment will be significant as it is the permanent secretary who will manage day-to-day interactions with oil companies: "*No decisions will be made until the permanent secretary is in office*"⁵.

With regard to transparency, Kenya is outwardly moving in the right direction and has pledged to become a signed up member of the **Extractive Industries Transparency Initiative (EITI)**. The oil sector has concerns, however, about longevity and certainty, with the government planning legislative reform. The previous parliament was meant to pass a new petroleum act before the election but failed to do so. The policy regime for mineral extraction, last updated in 1986, is flawed. It gives the cabinet secretary power over awarding licences with little space for parliamentary oversight. Kenya has already introduced new rules increasing signature bonuses that companies pay when granted a new licence, from \$300,000 to \$1 million. Oil company executives are concerned that new legislation will see revisions made to existing production sharing agreements, and doubt whether the government has considered the implications of retrospective indigenisation tenets.

*"If the government insists on a hypothetical 20% or 30% local ownership, similar to that in the mining sector, will the government or the stock market be able to cover 20 or 30% of past costs as well as future?"*⁶

The **World Bank** is advising the government on oil legislation revisions and how to regulate the sector under the eye of Kenya's **Energy Regulatory Commission**. A World Bank delegation met petroleum ministry officials in May, with a follow up expected in June when the World Bank will submit its final recommendations. New terms are likely to call for higher royalties and introduce mechanisms to revoke permits should companies fail to meet their commitments. The government is also considering imposing capital gains tax in transactions where an oil company transfers interests to third parties. This would follow a wider regional trend that saw **Mozambique** introduce a 32% tax on the sale of local assets by foreign companies in December 2012. The government is also moving away from an "open door policy" whereby a government committee determines licensing, to a more transparent competitive bidding, with nine new blocks currently demarcated. The timeframe for the legislative reform will only become clear with the appointment of the ministry's permanent secretary⁷.

³ Source, senior oil executive

⁴ Source, senior oil executive

⁵ Source, senior oil executive

⁶ Source, senior oil executive

⁷ Source, senior oil executive

Uncertainty in the sector also comes from the prospect of Kenyatta's trial at the **International Criminal Court**. One source in the oil sector claimed that, should the trial continue, there is concern that Kenyatta may fall back on the anti-western rhetoric that helped him win the election, *"this is the worst case scenario, as the oil companies from the Far East would be ready to step in very quickly."*⁸

The next few months will see rapid development in the sector with a number of significant events expected:

- **Africa Oil** announced on 13 May that its operator **Tullow Oil** had begun drilling at the **Ekuto** prospect in the **Lockichar Basin**, Turkana with results expected within 60 days⁹.
- **Taipan Resources** will spud **Bahasi 1**.
- **Tullow** will continue to explore and evaluate the **Ngamia-1** well in **Block 10BB** in Turkana and will post results in June.
- **Simba Energy** unveiled a deal in May with private equity backed oil explorer **Ajax Exploration** that should see drilling in **Block 2A** beginning next year.

Regardless of these developments, the nascent sector is already contributing to Kenya's economic growth with related companies making an entrance. A **Dow Chemicals** delegation visited **Nairobi** in May to discuss the establishment of manufacture and distribution entry points for the **Common Market for Eastern and Southern Africa (COMESA)**.

2.2 Trouble at old refinery hinders Kenyan attempts to become regional oil hub

The other end of the supply chain faces more acute difficulties and may thwart Kenyan attempts to establish itself as the dominant supply route of **Uganda** and **Rwanda**. Problems facing the refinery are symptomatic of Kenyatta apparently not giving due attention to a regional perspective within the oil sector.¹⁰ In May, the **Kenya Petroleum Refineries Ltd (KPRL)** warned that financial shortfalls debilitating East Africa's sole oil refinery near **Mombasa** could render it unable to refine petroleum products¹¹. The cause of the dispute is apparently an agreement signed in July 2012, by which the refinery now imports crude oil, refines it and sells it to oil marketers. This was a departure from the previous heavily- subsidised practice whereby oil marketers imported fuel and processed it at the refinery for a fee. The **Oil Industry Supply Coordination Committee (SupplyCor)** argued in an April 2013 letter to the civil service that inefficiencies at the plant mean that production processes at the refinery are more than \$0.11 more expensive than imported fuel, costing the

⁸ Source, oil sector analyst

⁹ Press release, 13 May 2013

¹⁰ Oil sector source

¹¹ Africa Review, 4 May 2013

Kenyan economy \$18.8m a month¹². SupplyCor has said that should this continue, it would launch a boycott of the refinery beginning June 30. The uncertainty around the plant may hamper its investment strategy, with **Standard Chartered** expected to table a financing plan to be approved by the board at a shareholders' meeting in July. The upgrade will mean the plant's processing capacity increases from 1.6 million tonnes of crude oil per day to 4 million by 2018¹³. Kenya hopes to raise \$100m in international finance to build a new oil jetty at Mombasa port, though has offered no timeline.

*"We would like a bit more forward thinking and pace, and for Kenyatta to seize the bull by the horns. He doesn't seem to realise that building regional infrastructure takes a very long time indeed."*¹⁴

3 Political Dynamics

3.1 Political landscape begins to clear under new constitution.

President Kenyatta has met a number of constitutional milestones as his administration take shape. On 15 May, Kenyatta's cabinet secretaries were sworn in after each successfully completed the parliamentary vetting process. The cabinet is a stripped down affair, with 18 appointees compared to 44 under the previous administration. In accordance with the 2010 Constitution, the majority of nominees for cabinet secretaries are technocratic. A typical appointee is **Henry K. Rotich** as finance ministry cabinet secretary. He has been a civil servant in the finance ministry since 2006, rising up to become head of macroeconomics. He spent the ten years prior to that working at the **Central Bank of Kenya** and acting as a consultant for the **International Monetary Fund**. Rotich holds a masters degree in public administration from the **Harvard Kennedy School**. The majority of the cabinet, in fact, hold postgraduate degrees and have held senior appointments in both the private and public sector. The extent of private sector experience is particularly notable. **Adan Mohamed** (industrialisation and enterprise) was chief administrative officer at **Barclays Africa** and was previously CEO of **Barclays Bank of Kenya**. **James Macharia** (health) was managing director of **NIC Bank Ltd**. Davis Chirchir (energy) coordinated the privatisation of **Telkom Kenya Ltd** and the establishment of **Safaricom Ltd**. There were only two political appointees, with **Najib Balala** (mining) and **Charity Ngilu** (land, housing and development) rewarded for the support they demonstrated to the **Jubilee** alliance.

Other key post holders:

¹² SupplyCor letter to the head of the civil service, 19 April 2013

¹³ Reuters, 2 May 2013

¹⁴ Source, oil sector analyst

- Ambassador **Amina Mohamed** (foreign) is a former assistant secretary general and executive director of the **United Nations Environment Programme** in Nairobi (2011- 2013). She is a former permanent secretary at the justice and constitutional affairs ministry (2008- 2011). A lawyer by training, Mohamed served as a legal advisor in Kenya's foreign affairs ministry and as a legal advisor to Kenya's delegation to the UN in **Geneva** and to the delegation to the **Security Council** in **New York**. In 2005, Mohamed became the first woman to chair the **World Trade Organisation's (WTO)** general council. She had previously been in the running to replace **Pascal Lamy** as the head of the WTO.
- **Raychelle Omamo** (defence) had previously served as Kenya's ambassador to **France, Portugal** and **Serbia**. A lawyer by training, she rose to senior counsel in Kenya's high court and was the first female chair of the **Law Society of Kenya**. Omamo was also a member of the task force that established the **Truth, Justice and Reconciliation Commission** and acted as assisting counsel to the **Ndung'u Land Commission**, established in 2003 to investigate the allocation of public land to private individuals.

The transition to the devolved system of government has also continued at pace. The Treasury, the Commission for the Revenue Allocation and the Transition Authority settled on an allocation of Sh230 billion (\$2.7 billion) to county governments.¹⁵ This would represent 31.2% of the national budget, above the 15% codified in the constitution. The National Assembly passed the division of revenue bill containing these figures. The Senate is currently discussing the bill.

A number of domestic challenges, however, face Kenyatta. MPs continue to demand that their salaries should be increased, voting to overturn a directive that would have reduced their pay from \$126,000 to \$78,000. This triggered public protests in May outside the parliament buildings in Nairobi, and is likely to be a source of future contention¹⁶. Kenyatta has urged MPs to follow the salaries and remuneration commission whose chair, **Sarah Serem**, has said it is committed to reducing the state's wage bill¹⁷. At the same time, the Commission has granted increases in allowances afforded to county level officials¹⁸. Again, this is liable to be a source of tension in the future. The roll out of the constitution is also setting the framework for future litigation, notably with regard to appointments made at county level. The constitution insists on five years experience and at least 30% women office holders and representation for minorities. In one county, applications for posts were advertised and filled within two days, suggesting that there was a preordained list.

4 Operations

4.1 Violent crime increases across Kenya

¹⁵ Standard, 8 May 2013

¹⁶ The Star, 14 may 2013

¹⁷ The Star, 14 may 2013

¹⁸ Daily Nation, 18 May 2013

Violent crime has increased across Kenya. In the **Northeastern** province, Islamist militants have continued a campaign of violence against government and security officials. In April, they expanded their targets to attack a hotel in **Garissa** killing ten people. President Kenyatta responded in a tough manner, deploying a rapid deployment unit that detained over 100 suspects. He also ordered a high-level security team to visit the restive city. The team dismissed the head of Garissa's criminal investigations department on 21 April when it was discovered that eleven police officers had links with **al Shabaab** militants. The team either had very early successes in their investigations or the militant/police link was already known but had not been investigated. The latter is more likely with corruption rife in Kenyan police circles. Kenyatta also demonstrated greater political will to address clan clashes in the northeastern province, deploying troops in **Mandera** to stop clashes between **Degodia** and **Garre** militia. Kenyatta has also begun the process of reviving the **Kenyan Police Reserve**, an armed and trained civilian corps, in Garissa. In May, the **Truth, Justice and Reconciliation Commission** delivered its final report to Kenyatta, detailing human right abuses committed by the government during the **Shifita** (1963- 1967) war against ethnic **Somalis** in Kenya. This should prove a timely and appropriate lesson to Kenyatta about the dangers of a propensity to deploy troops without a political solution to address social and economic grievances.

There has been a wave of violent robberies and armed burglaries in Nairobi. Nairobi residents report police involvement, raising fears of a return to high levels of violent crime and increasing fears that police are freelancing. "Armed" robbers held up a foreign correspondent walking in her neighbourhood in downtown Nairobi. While crime has been habitual in the city, the violence displayed in recent months is worthy of note. On May 13, unknown gunmen shot dead two civilians, including a local government official, and a police officer in two separate robberies¹⁹. In the first incident, unknown gunmen killed Nairobi county transitional authority coordinator, **Eliud Baraza**, after stealing his laptop at the **Tena** residential estate, **Eastlands**. In the second incident, five heavily armed gunmen killed a police officer who had stopped their carjacked vehicle near the centre of Nairobi.

In the **Western** province meanwhile, criminal gangs – rumoured in the local media to have links to local politicians – have been targeting businesses in **Bungoma** and **Busia**²⁰. Kenyatta has again responded by deploying more police officers. The government has announced that it plans to appoint 10,000 more police officers to address rising crime across Kenya. The Kenyan police force is, however, increasingly disillusioned. Many risk losing their jobs due to qualification requirements in the constitution, while the inspector general of police, **David More Kimaiyo**, has called for greater training and remuneration for officers²¹. Kimaiyo is committed to reforming the police service, but this process has been hit by a number of obstacles. Kimaiyo

¹⁹ Xinhua, 13 May 2013

²⁰ Standard, 17 May 2013

²¹ Standard, 17 May 2013

abolished the office of provincial police officers, but has blamed a lack of funding from the government for the delay in replacing them with the new position of county commanders²².

5 Implications

The oil sector will continue to remain cautious until the government's legislative framework is in place. According to a source in the sector, oil companies will for the most part be willing to renegotiate production sharing agreements if this is a guarantor of future stability in the sector and if it allows them the opportunity to negotiate with the government about what local ownership provisions will mean in practice. The ministry has retained most of its technocratic staff, meaning that it is unlikely that the government will tear up the draft petroleum act or make any policy lurches. The picture should therefore be clarified in the next couple of months. Upstream providers will continue to enter the market, boosting the wider economy. Stable macroeconomic growth will ensure that Kenya's current account deficit is projected to narrow despite the rise in capital goods imports financed by foreign direct investment in oil exploration equipment. Delays to parliamentary business can be expected if the parliamentary committee formation process is not completed by the end of the month as expected. This will jeopardise the ability of the government to present the final budget for the new financial year in June as per the fiscal agenda.

A technocratic, pro-business and professional cabinet should result in efficient policy making, although the mass of legislation needed to implement the constitution will throw up some political battles as politicians and officials become accustomed to their roles and responsibilities. The retention of **Francis Kimemia** as secretary to the cabinet and **Lawrence Lenayapa** as comptroller of State House should contribute to a smooth transfer from the previous administration. Technocratic continuity at the finance ministry and **Central Bank** should mean that overall fiscal policies and trends continue.

The security situation in northeastern province will remain precarious until the government addresses local economic and social grievances. Devolution could exacerbate the situation, as already deprived provinces struggle to attract the levels of investment that more productive regions such as Nairobi and Mombasa do. Reform of Kenya's police force is long overdue. Whether Kimaiyo is able to achieve it will depend on levels of political will and funding from within the central government. It will, regardless, be a long process and we encourage extra vigilance in Nairobi.

²² Sabahi, 15 May 2013