



Mixed Blessing?

**Promoting Good Governance
in Kenya's Extractive Industries**

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Foreword

As Kenya establishes the framework for exploitation of recent discoveries of large oil and gas deposits, the need for good governance in the sector becomes paramount. Related experience reveals that resource-rich developing countries often face a range of challenges in translating the potential benefits from such discoveries into the improved welfare of their citizens. The result is that the abundance of natural resources in most developing countries causes significant harm rather than bringing the expected benefits. This paradox where natural resource endowments occasion misery instead of plenty is well illustrated by crises in African mineral and oil exporters such as Sudan, Angola, Democratic Republic of Congo (DRC), Chad and Equatorial Guinea. These countries are often said to be suffering from the 'resource curse'. This describes a range of tribulations that stalk the exploitation of natural resources amidst bad governance. It manifests itself in political conflict over the resources, declining industries, increased inequality, environmental pollution, exacerbated corruption and weak government institutions that are unable or unwilling to manage the resources effectively.

To avoid going down the same path, Kenya will have to prepare itself well by adopting best practices and establishing strong safeguards in its extractive sector at an early stage. In this analysis, the main focus will be on the oil sector.

It is in recognition of the dangers implicit in sudden access to large mineral resources, given Kenya's experience of sporadic violent conflict and its extremely poor corruption record, that the Africa Centre for Open Governance (AfriCOG) has produced this report.

We hope that this study will help to inform civil society's efforts to provide oversight, demand accountability and monitor Kenya's preparations to become an 'extractive-industry nation'. The research for this work was accomplished during the latter part of 2013 and early 2014.

Gladwell Otieno

Executive Director, Africa Centre for Open Governance (AfriCOG)

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Abbreviations and Acronyms

AfriCOG	Africa Centre for Open Governance
API	African Petroleum Institute
CS	Cabinet Secretary
CSR	Corporate Social Responsibility
DFID	Department for International Development
EAC	East African Community
EITI	Extractive Industry Transparency Initiative
ERC	Energy Regulatory Commission
FOI	Freedom of Information
GDP	Gross Domestic Product
HSF	Heritage and Stabilisation Fund
ICES	Information Centre for the Extractive Sector
ICMM	International Council on Mining and Metals
IMF	International Monetary Fund
KEPTAP	Kenya Petroleum Technical Assistance Project
KPTJ	Kenyans for Peace with Truth & Justice
LAPSSET	Lamu Port Southern Sudan- Ethiopia Transport
MT	Metric Tonnes
NAFFAC	National Fossil Fuels Advisory Committee
NCD	Nigerian Content Division
NEMA	National Environmental Management Authority
NGO	Non-Governmental Organisation
NLC	National Land Commission
NOCK	National Oil Corporation of Kenya
NOCs	National Oil Companies
NRC	Natural Resource Charter
OBI	Open Budget Index
OTO	Oil Taxation Office
PIAC	Public Interest and Accountability Committee
PSC	Production Sharing Contracts
PWYP	Publish What You Pay
NRGI	Natural Resource Governance Institute

Executive Summary

Since the announcement of the first discovery of oil in March 2012, Kenya has seen further discoveries of large oil and gas deposits. On 22 November 2013, UK's Tullow Oil and its exploration partner, Canada-based Africa Oil, announced the finding of oil in a fifth exploration well in Turkana County, the South Lokichar basin. Tullow's reserve estimates stand in excess of 600 million barrels of oil with the company indicating that the basin has the potential to yield over one billion barrels. The country is set to start mass extraction of these natural resources, with oil production expected to start in 2016. In addition, Kenya recently recorded increased discovery of mineral resources and rare earth elements, expanding its mining ventures in various parts of the country. Accordingly, it is now recognised that Kenya is endowed with vast and valuable natural resources.

However, global trends have revealed that without good governance in the extractive industries, the natural resource-rich countries especially in Africa are at the risk of suffering from the 'natural resource curse' and the 'Dutch disease'. The discovery of oil becomes the cause increasing the misery for the people rather than improving their welfare. The natural resource curse sometimes called 'the paradox of plenty', refers to a puzzle where countries with rich natural resources- particularly oil - tended, in the long term, to record slower economic growth than countries with fewer natural resources. The natural resource curse now refers to a wide range of issues where the extraction of a country's natural resources causes significant harm rather than bringing benefits. For instance, political conflict over the resources, high inequality in the sharing of benefits, environmental pollution, corruption, weak government institutions that are unable or unwilling to manage the resources effectively and rent seeking. African oil exporters such as Sudan, Angola, Chad and Equatorial Guinea are very often said to be suffering from the curse.

Similarly, the 'Dutch disease' refers to a situation where growth in national income from natural resource extraction damages or crowds out other sectors of a country's economy; the economy becomes over-reliant on the extractive resources that it is exporting while neglecting other sectors such as agriculture and manufacturing in favour of the quick and significant returns to be had —and this can be particularly damaging if, for any reason, there is a drop in world price for those natural resources.

In view of these dangers this study examines the growing oil sector in Kenya and comes up with recommendations for entrenching best practices in the governance of Kenya's extractive industries with a focus on the oil sector.

Consequently, this study is based on five themes: -

First, the study examines the evolving policy, regulatory and institutional frameworks since the discovery of oil in Kenya. The policy, legal and regulatory framework that were discussed comprise Sessional Paper No. 4 of 2004, the Energy Act and Kenya Vision 2030. The overall energy institutional frameworks include the Energy Tribunal, Ministry of Energy, Kenya Pipeline, National Oil Corporation of Kenya (NOCK) among others.

The second part largely looks at the preparations of the government so far, through the Ministry of Energy and Petroleum towards the extraction of oil. Some of the issues that emerge from this part include the need for greater efforts towards learning from other countries that have active oil extractive industries; for extensive engagement with stakeholders and consultation with communities; review/revision of Energy policy and Energy Act, the development of new Production Sharing contracts (PSCs); the progress of the 'Local Content Framework', review and entrenchment into law of the National Fossils Fuels Advisory Committee (NAFFAC) and other recommendations.

Thirdly, the report discusses the effect of oil discovery on local communities. Here it classifies oil exploration areas into two: offshore exploration which is off the coast of Lamu and onshore exploration which covers Turkana County. Among the issues of concern that arise between oil companies and local communities, especially in Turkana County are meaningful community engagement, land use, environmental protection, employment, procurement opportunities and substantial corporate social responsibility activities. This part concludes by highlighting the responsibility of the government to ensure sustainable development especially for people living in oil exploration areas.

This conclusion leads us to the fourth part of the report which comprehensively discusses best practices to promote good governance and address corruption in the oil sector. Indeed, this is invaluable given the unimpressive record of Kenya's anti-corruption efforts. Here, some of the best practices in the oil extractive sector applicable to the Kenyan situation that are discussed include:

- The Extractive Industries Transparency Initiative (EITI)
- The Natural Resource Charter (NRC)
- Establishment of a sovereign fund (including its management) with public and civil society oversight.
- Open tendering
- Transparency in PSC contracting
- Public sharing of PSCs and revenue streams
- Revenue collection, management and distribution using public and civil society involvement and oversight
- Revenue sharing

Finally, the fifth part contains recommendations for entrenching best practices in the governance of the oil sector in Kenya. These recommendations are based on the best practices discussed previously, including how to ensure that the local communities are protected and that they benefit appropriately, focusing on the necessary legal and institutional mechanisms and the relationships between the two. There are two sets of recommendations. First, recommendations are made on the key issues involved in building the confidence of the Kenyan public in the government's ability to manage the extractive industry, and in particular oil, on the people's behalf. Then, secondly, the report identifies key institutions and actors in Kenya's oil sector and makes recommendations for each, which collectively will ensure that the discovery of oil profits all Kenyan people.

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Additional information is contained in the annexes to this report. Annex I is dedicated to deeper explanation of legal and institutional frameworks in Kenya's oil exploration while Annex II is about global institutions and international efforts towards good governance in extractive industries.

Introduction

High crude oil prices worldwide in 2003/2004 and a commercial oil discovery in Uganda in January 2006 led to renewed interest in Kenya's under-explored basins. On 22 November 2013, UK's Tullow Oil and its exploration partner, Canada-based Africa Oil, announced the finding of oil in a fifth exploration well in the South Lokichar basin. Since the announcement of the first discovery of oil in March 2012, Kenya has seen increased uptake of oil block licences.¹ While no other discovery has been made, more and more companies have commenced exploration activities in Kenya.²

Tullow's reserve estimates stand in excess of 600 million barrels of oil³ with the company indicating that the basin has the potential to yield over one billion barrels.⁴ Oil production is expected to start in 2016.

In addition, Kenya recently recorded increased discovery of mineral resources and rare earth elements, expanding mining ventures in various parts of the country. Within the last few years, extractive resources have also been discovered that include natural gas reserves in Malindi, coal in Kitui (Block C of Mui basin appraised at 400 million tonnes [MT]), titanium, niobium and rare earths in Kwale, while significant deposits of iron ore, as well as minerals like calcium and gemstone, are exploited freely in Taita Taveta.⁵

Combined revenue from these mineral exports (excluding titanium and coal) is expected to earn Kenya over US\$240 million annually. Oil and titanium revenues, the latter whose first cargo of 25,000 MT, estimated to be worth US\$3.78 million, was exported in February 2014, are forecast to boost this significantly.⁶

It is now recognised that Kenya is endowed with vast and valuable natural resources. While their contribution to Kenya's GDP is currently low and stagnant (0.7 percent mining and quarrying in 2010 and in 2012) this is expected to shoot to over 30 percent and closer to 70 to 80 percent, depending on oil finds, in five to seven years when productions starts.⁷ This report focuses on the oil sector although it comprises broader lessons that would apply to the extraction of other natural resources.

1 Kenya has 46 exploration blocks onshore and offshore in four basins: sedimentary basins: Anza, Lamu, Mendera and the Tertiary Rift. 44 out of the 46 blocks are licensed to 26 oil companies, including the National Oil Corporation of Kenya. 10 newly relinquished areas are awaiting gazettment as blocks available for lease.

2 Other companies with exploration blocks in Kenya include: A-Z Petroleum Products, Adamantine Energy, EAX/Afren, Africa Oil Corp, Anadarko, Apache, BG, CAMAC Energy, EDGO, ERHC, ENI, FAR/Flow Energy, Imara Energy, Lamu Oil and Gas, Lamu Exploration Ltd, Lion Petroleum, Ophir/Dominion, Pacific Seaboard, Rift Energy, Simba, STATOIL, Taipan, Total, Vanoil, and Zarara.

3 On 15 Jan 2014 Tullow doubled its estimates after oil discoveries at the Amosing-1 and Ewoi-1 exploration wells in Block 10BB onshore northern Kenya. This is in addition to reported discoveries at Ekales-1 and Agete-1.

4 That compares with Uganda's estimated 3.5 billion barrels of reserves.

5 See: Scola Kamau and Christine Mungai, Kenya hits \$100bn rare earth jackpot, <http://www.africareview.com/Business---Finance/Kenya-hits-rare-earth-jackpot/-/979184/1922054/-/pq4bu9z/-/index.html> and <http://www.energy.go.ke/index.php/events/finish/3-ministerial-documents/25-energy-day-prospectus>

6 See: Joshua Masinde, Base Titanium makes its first mineral shipment from Kenya, <http://www.investmentkenya.com/latest-news/436-base-titanium-makes-its-first-mineral-shipment-from-kenya>

7 See Ian Armitage, Kenya's Extractive Industries Attract Attention, <http://www.africaoutlookmag.com/content/kenya%E2%80%99s-extractive-industries-attract-attention> and Information Centre for Extractives Sector, <http://ices.or.ke/facts/>

Even at the low 30 percent GDP forecast for oil and gas (excluding mining), the oil and gas sector would be the largest contributor to the national economy, overtaking agriculture and forestry. Good governance of this sector is therefore critical and urgent, given the reputed plans for oil production, Kenya's own track record on corruption, and the phenomenon of the 'resource curse'⁸ that afflicts many new oil-rich countries.

Oil is a blessing, but it can also be a curse. If Kenya manages its oil resources well it can strengthen its economy and lift millions of citizens out of poverty. If the sector is mismanaged then the country risks experiencing some problems commonly associated with long-term trends in world commodity prices, volatility, crowding out of manufacturing, civil war, poor institutions, and the 'Dutch Disease'.⁹

To avoid going down this path, Kenya will have to erect strong safeguards in its oil extractive sector at an early stage. This study has been developed to help inform civil society's efforts to monitor Kenya's preparations to become an 'extractive-industry nation' and identify gaps where strong mechanisms for accountability and oversight are needed.

1. The evolving policy, regulatory and institutional framework since the discovery of oil in Kenya

Excavation for oil in Kenya started in the 1950s¹⁰ when British Petroleum (BP) and Shell started investigating the Lamu Basin. Despite significant indications of the presence of hydrocarbons in the area, no exploitable oil deposits were found and successive attempts did not yield much fruit. In 1995, the National Oil Corporation carried out an in-depth analysis of Lamu Basin's geological and geophysical characteristics. This analysis gave renewed attention to oil exploration and from 2000, offshore Production Sharing Contracts (PSCs) were awarded.

Policies, legal and regulatory framework

The Petroleum (Exploration and Production) Act enacted in 1984 and revised in 1986, when Production Sharing Contracts (PSC) replaced royalties, was the first comprehensive law on oil in Kenya. The sector was regulated through the Petroleum (Exploration and Production) Act of 1994 and the Petroleum Development Fund Act of 1991. The broad-based energy sector reforms were laid out in Sessional

8 A paradoxical situation in which countries with an abundance of non-renewable resources experience stagnant growth or even economic contraction.

9 Dutch disease refers to the deindustrialisation of a nation's economy that occurs when the discovery of a natural resource raises the value of that nation's currency, making manufactured goods less competitive with other nations, increasing imports and decreasing exports. The term originated in Holland after the discovery of North Sea gas.

10 "Emerging East Africa Energy" _Energy Information Agency, 23 May 2013.

paper no 4 of 2004 while the Energy Act, No.12 of 2006 laid the foundations for the liberalization of procurement, distribution and pricing of petroleum products in the country.¹¹

Sessional Paper No. 4 of 2004

Sessional Paper No. 4 of 2004 provides the overall policy framework for the energy sector and the unbundling of functions in the electricity and petroleum sub-sectors. It has therefore consolidated all energy laws under a re-mandated regulatory commission with a strengthened function. Its vision is to promote equitable access to quality energy services at the least cost while protecting the environment. The sessional paper therefore lays out the policy framework upon which cost-effective, affordable and adequate quality energy services will be made available to the domestic economy on a sustainable basis over the period 2004-2023. The specific objectives of the energy policy are to:

- Provide sustainable quality energy services for development
- Utilise energy as a tool to accelerate economic empowerment for urban and rural development
- Improve access to affordable energy services
- Provide an enabling environment for the provision of energy services
- Enhance security of supply
- Promote development of indigenous energy resources
- Promote energy efficiency and conservation as well as prudent environmental, health and safety practices.

In order to achieve these objectives the sessional paper introduced a number of energy sector reforms. In the petroleum sub-sector the proposals in the sessional paper include:

- Divesting of government interest in oil refining and marketing and eventually in the Kenya Pipeline Company (KPC)
- Advocating for the promotion of investments in oil refining including supply and distribution of petroleum products throughout the country.
- Enhancing the exploration of fossil fuels particularly hydrocarbons through sub-division of exploration acreage into smaller blocks and collection of additional geological data to attract more oil prospecting companies.
- Financing strategic energy reserves by the government and private sector, equivalent to 90 days demand in the medium to long term.
- Strengthening regional and international cooperation to promote data and information exchange on oil exploration.

Energy Act of 2006

The Energy Act of 2006, whose basis is the Sessional Paper no. 4 of 2004, consolidates all laws relating to the energy sector in Kenya. Within the petroleum sub-sector, the Act provides for the establishment

¹¹ By the time of printing this publication, The Mining Bill, 2014 had been passed by Parliament and was awaiting Presidential assent. The Bill seeks to consolidate laws relating to minerals to ease the sector's administration.

of the Energy Regulatory Commission (ERC) while outlining its functions and powers. The Act also establishes the Energy Tribunal whose purpose is to hear appeals from decisions of the ERC. The institutional setup situates the two bodies, namely the ERC and the Tribunal as overall regulatory bodies independent of state influence. The two coordinate and advise the Ministry of Energy on policy and strategy. Currently a review process is on-going with a view to strengthening the mandates of the existing institutions. Proposed reforms in the sub-sector include the addition of the energy policy and integrated energy plan to the Act, together with the establishment of a National Energy Regulatory Commission, a National Energy Institute, an Energy Efficiency and Conservation Agency and a Nuclear Electricity Corporation. The review also incorporates coal regulations. The resulting bill repeals the Energy Act of 2006, the Geothermal Resources Act and the Petroleum (Exploration and Production) Act.

Kenya Vision 2030

Kenya Vision 2030 is the long-term development blueprint for the country. On energy, Vision 2030 notes the high and unsustainable energy costs and prioritizes the growth of energy generation as well as increased efficiency in energy consumption. It is envisaged that this will be achieved through continued institutional reforms in the energy sector, including a strong regulatory framework, encouraging private generators of power, and separating generation from distribution. In addition securing new sources of energy through exploitation of geothermal power, coal, renewable energy sources, and connecting Kenya to energy surplus countries in the region are essential. Within the second Medium Term Plan (MTP-II), the government proposes to undertake various projects between 2013 and 2017. These include the exploration and development of oil and other mineral resources and more specifically:

- Subdividing and creating new petroleum exploration blocks based on technical data
- Enhancing primary data acquisition, analysis and interpretation in the open blocks so as to make them attractive to investors
- Establishing a National Petroleum Data Centre
- Conducting a National Airborne Geo-physical Survey
- Establishing an internationally accredited Mineral Certification Laboratory and Audit Agency
- Establishing a Minerals and Metal Commodity Exchange
- Creating Special Mineral Processing Economic Zones
- Enhancing partnerships in data exchange so as to reduce costs in exploration and access to new technology
- Developing skills and enhancing local expertise in petroleum exploration and production through training, technical collaboration with exploration companies and universities.
- Restructuring and enhancing the National Oil Corporation of Kenya financial capacity to conduct up-stream business.
- Starting commercial production of the Kwale Mineral Sands project in 2014
- Developing the rail and road networks for exploitation of the coal deposits in Mui Basin and other parts of the country
- Developing logistics and supply chains management for the oil, gas and other minerals
- Effectively managing the environment and social footprints.

Other programmes and projects include:

- Establishing a regional geological survey and research centre.
- Mineral exploration and evaluation.
- Undertaking geo-hazard mapping and monitoring.
- Establishing a Mineral Sovereign Fund.
- Establishing a National Seismological Network.
- Developing the LAPSET corridor which includes construction of 1,400 km of crude oil pipeline from Lamu to Juba in South Sudan, an oil refinery in Lamu with a capacity for 120,000 barrels per day, a modern oil terminal at Lamu port to facilitate tanker loading and offloading, a second oil pipeline to transport refined oil product to the Ethiopian market, and construction of a pipeline from Lamu to the existing Mombasa-Kampala pipeline.

Institutional framework

The overall energy institutional framework includes:

Ministry of Energy

The Ministry of Energy and Petroleum is responsible for overall policy coordination and development in the energy sector in Kenya. It is responsible for setting policy upon receipt of advice from the ERC and the Tribunal.

Energy Tribunal

The Energy Tribunal is established under the Energy Act of 2006. Its main function is to hear appeals from decisions made by the ERC.

Energy Regulatory Commission

The ERC approves operational permits and authorizations 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 and the Tribunal are overall regulatory bodies independent of state influence. The two coordinate and advise the Ministry of Energy on policy and strategy.

Under the petroleum sub-sector, the institutional framework includes:

Kenya Petroleum Refineries Ltd (KPRL)

Direct government involvement in the petroleum industry is in the oil refinery, where it co-owns KPRL with three private companies (Shell, BP Petroleum and Caltex) on a 50/50 equity basis, and in oil storage facilities at Kipevu.

Kenya Pipeline Company (KPC)

The government through KPC has 100% equity. It owns a petroleum pipeline that runs from Mombasa to Nairobi and western Kenya with terminals in Nakuru, Eldoret and Kisumu.

National Oil Corporation of Kenya (NOCK)

The government is also the sole owner of NOCK, which is involved in oil supply and distribution. NOCK also undertakes oil exploration on behalf of the government. The original government objective was to use NOCK to regulate petroleum market prices through competition, following the deregulation of the industry in 1994.

Private marketers

The private sector has an extensive network of distribution and marketing outlets in different parts of the country and accounts for about 99.4% of the total market sales of petroleum fuels. Seven oil companies, Shell, BP, Total, Mobil, Kenol, Kobil and Caltex account for about 85% of the total sales leaving the balance of 15% to NOCK and several small companies

2. Efforts of the Ministry of Energy and Petroleum so far

The Ministry of Energy and Petroleum has, since its discovery, been preparing for the extraction of oil in various ways, including the awarding of tenders and learning from other countries that have active oil extractive sectors. Its actions so far include:

- The Ministry visited the following oil extractive countries:
 - In 2012 the then Minister for Energy, Hon Kiraitu Murungi and the Permanent Secretary, Patrick Nyoike, visited Ghana and Nigeria
 - In 2012 the Permanent Secretary, accompanied by the National Fossil Fuels Advisory Committee (NAFFAC) visited Trinidad and Tobago.
- The Ministry intensified primary data acquisition in the available blocks to make them more attractive to investors and to fast track petroleum discovery in other exploration blocks.

The Ministry of Energy and Petroleum has also engaged extensively with stakeholders within national and county governments, including all relevant government agencies that have, or will have a bearing on oil production. However, little to no engagement and consultations with communities and the public by the Ministry appears to have taken place, according to interviews undertaken by AfriCOG.

- The Ministry has funded the expansion of NOCK's exploration laboratory to the tune of US\$300 million.
- In 2012/2013 the Ministry received a grant from the World Bank and the IMF that helped it to identify gaps and areas for strengthening oil management operations.
- A further US\$50 million project loan by the World Bank titled 'Kenya Petroleum Technical Assistance Project' (KEPTAP) has been under discussion since the fourth quarter of 2013 to assist Kenya to prepare for oil production. It was expected to be signed in February 2014 but had not been signed at the time of publication of this study. Canada has also offered a US\$9 million grant to this project, coordinated by the World Bank. KEPTAP has four components:
 - Petroleum sector reforms and capacity building
 - Revenue and investment management – reforms and capacity building
 - Sustainable impact of the oil and gas industry
 - Project management. (Already a project preparation advance of US\$3 million to set up the KEPTAP management unit has been initiated.)
- The task force for the Energy Policy and Energy Bill was also mandated to develop new production sharing contracts (PSCs)¹² for oil and gas; this is currently underway. Issues the task force is considering include specific technical advice given in July 2013 by the International Monetary Fund (IMF) on:
 - Specific design of new PSCs for oil and gas
 - Economic provisions of the Model PSC
 - Additional tax devices for mining such as allocation of mineral rights
 - Application of VAT to mining and petroleum exploration
 - Income tax reforms for mining and petroleum
 - Implementation of the 'Pay-on-behalf' scheme for corporate income tax in PSCs to enable deduction of taxes by government before the sharing of income between the companies and the government
 - Decentralisation of extractive industries revenues e.g. by sharing them or distributing them among the different sub-national governments
- A revised draft of the Energy Policy¹³ was published in November 2013 and included the following proposals:
 - Set up a refinery (in addition to that of Mombasa) in Lamu or Isiolo (or any appropriate place) to develop adequate national production capacity
 - Adopt and implement an Extractive Industries Transparency Initiative (EITI) charter by 2017
 - Reconstitute and anchor into law a new National Fossils Fuels Advisory Committee

12 Production Sharing Contracts are a type of agreement signed between a government and a company extracting natural resources; the company undertakes the financial risks associated with exploration and recovers these costs if and when the resource, in this case, oil is discovered and extracted. Any costs above these are shared between the government and the company.

13 <http://www.energy.go.ke/index.php/events/finish/3-ministerial-documents/41-national-energy-policy-november-2013-draft>

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- Develop mechanisms for sharing benefits between national and county governments and the community as per Article 69 of the Constitution by 2017
 - Cement plans to build a 1400 km oil pipeline from Juba to Lamu under the LAPSSSET (Lamu Port Southern Sudan-Ethiopia Transport) project
 - Review the Petroleum Act, Cap 308, by 2017 to incorporate industry best practice and deal with gas sharing terms, compensation, windfall profits, royalties and corporate social responsibility
 - Review the Model Production Sharing Contract by 2017.
- The Energy Act was also revised and a draft Bill¹⁴ was published in November 2013. The following highlights, amongst others, were proposed:
 - A proviso that the Cabinet Secretary (CS), Energy and Petroleum may “adopt acceptable international standards in the management of resources provided that such standards are not inconsistent with [the] Act”.
 - Share petroleum revenue allotting 80 percent to the national government, 15 percent to the county government and 5 percent to the local community, paid through the relevant county government.¹⁵
 - Set up a sovereign fund, managed by the national government, into which such oil revenues (as determined by the CS Treasury) will be received. The sovereign fund will, in addition to developing infrastructure, serve as a savings base for Kenyans and an endowment fund for future generations.
 - The CS Treasury will appoint the sovereign fund manager AND determine amounts payable into the fund and withdrawals made from it.
 - NAFFAC to be entrenched into law and, while it may co-opt up to four members, it is to comprise 100 percent national government representatives.
 - Oil exploration licences to be subject to cabinet approval and ratification by Parliament.
 - Give supervision powers of petroleum operations to the CS Energy and Petroleum.
 - In August 2013 Adam Smith International (working on behalf of the UK Department for International Development [DFID] and other donors) conducted a study on the extractive industries in Kenya and, based on multi-stakeholder consultations, made the following recommendations:¹⁶
 - Develop, agree and implement a coordination mechanism for the extractive sector i.e. mining (minerals and coal) and petroleum
 - Develop a vision for the extractives sector through wide and meaningful consultation
 - Design and implement a strategy to communicate the vision and manage expectations
 - Develop a legal and policy framework for the extractives sector

14 <http://www.energy.go.ke/index.php/events/finish/3-ministerial-documents/40-the-energy-bill-2013>

15 Section 126 (1) and (2) of the draft Energy Bill, 2013.

16 Recommendations for the Development of Kenya's Extractive Industries: *Based on multi-stakeholders consultation*. Department for International Development, August 2013 – Final Draft Report.

- Develop a framework to manage revenues optimally over time
 - Develop a tax regime that attracts investment and optimises revenue
 - Establish a process to ensure transparency and accountability in the extractives sector
 - Create wealth and jobs for Kenyan companies and citizens
 - Develop skills to supply (directly and indirectly) to the extractives industry and downstream industries
 - Develop a policy framework for regional cooperation and infrastructure
 - Develop and implement a community development framework
 - Design and implement county development programmes
 - Conduct Kenya-East African regional strategic environmental and social assessments
 - Focus on artisanal mining development
 - Establish a fit-for-purpose institutional framework
 - Transform the capacity of key institutions and stakeholders.
- There has been heightened interest in Kenya extractive sector which has meant more leasing of blocks - 11 blocks have been leased since oil discovery in March 2012.

The Kenya Revenue Authority is in the process of setting up a specialised Upstream Oil Unit to handle the oil producing sector and has held several meetings with the International Monetary Fund (IMF) and the World Bank on 'Best Oil Tax Practices' as well as being involved in sector discussions.

In October 2012 the National Treasury sent two of its staff on an EITI workshop in Zambia and discussions are on-going for Kenya to join the EITI.

- A team of public and private sector stakeholders is working on an extractives sector 'Local Content' framework. It is not clear when this will be finished, but one proposal is to get this reviewed and endorsed before, or during June 2014, in time for the very first local content conference scheduled for the third week of June 2014, in Nairobi, Kenya. The draft Bill, however, does not enhance the statement in the current Act that encourages companies to work towards local content without specifics.

In August and September 2014 the National Oil Corporation of Kenya (NOCK) plans to send 34 young Kenyans for technical training in Australia, Canada, the UK and the USA to build capacity in implementing the NOCK's growth strategy. These include seven geologists, seven geophysicists, seven geochemists, nine petroleum engineers, two petroleum lawyers and two petroleum economists funded through the Training Levy Fund under the Petroleum (Exploration) Act Cap 308.

3. The effect of the discovery of oil deposits on local communities

Oil exploration in Kenya is largely concentrated in offshore blocks off Lamu, onshore blocks in northern Kenya and one in Magadi, in the south western part of Kenya.

Offshore exploration

Although offshore oil exploration affects marine life, it is too early to assess the impact of this on the livelihood of the local community in Lamu. The exploration takes place far from the coastline and the local population has little contact with the operations of oil companies. In addition, the scale of oil exploration activities off the coast of Lamu is still at the exploratory stage, as compared to Turkana where a commercial discovery has been made. However, if and when a commercial discovery is made in Lamu (and in other areas currently under exploration), then the expectations of the local communities will be raised. These in turn may further fuel the ethnic, political and religious tensions in Kenya's coastal regions, if not properly addressed.

Onshore exploration

Onshore oil exploration activities, such as those taking place in Turkana, are happening adjacent to the local communities, increasing the chances of possible conflict between the company and the communities.

The relationship between communities and oil companies, such as Tullow Oil, which operate in Turkana, has not been positive, raising a number of grievances¹⁷ on the part of the local community. On 27 October 2013, simmering tensions between the community and the company led to community members invading two facility camps demanding jobs and supply contracts for local people. This action culminated in the suspension of operations in Block 10BB and Block 13T.¹⁸ The grievances against Tullow Oil reportedly revolve around community engagement, land use, environmental protection, employment, procurement and corporate social responsibility.

- **Community engagement:** A major concern exists over Tullow's engagement with local community leaders.¹⁹ According to the latter, since 2011, they have been demanding involvement in decision-making processes relating to the oil sector in Turkana. While they admit that they have had occasional meetings with company representatives, they believe that the company management has not taken

17 Interviews were conducted with community members, a local civil society organization and an international civil society organization in Turkana. Tullow did not respond to a request for an interview. The Ministry of Energy and Petroleum also did not respond to a request for an interview on the governance of the oil sector in Kenya.

18 <http://www.the-star.co.ke/news/article-141340/locals-storm-tullow-oil-fields-turkana>

19 Report of Turkana South and East Sub-Counties Leaders on Issues to be Addressed by Tullow and the Government of Kenya, District Advisory Committees of Turkana South and East, Elected Leaders, Opinion Leaders and other Stakeholders, October 29, 2013.

them seriously. They cite examples where Tullow officials cancelled meetings meant to discuss key issues affecting the community. Community leaders demanded that Tullow establish a local office in Turkana where issues of concern to the community can be addressed on a regular basis.

- **Land use:** Rural inhabitants in Turkana represent 85 percent of the county's nearly one million residents.²⁰ The majority of the rural people lead nomadic or semi-nomadic lifestyles that depend on livestock and grazing land. Community leaders complain that nomadic people have lost access to grazing land and that they have not been compensated. They also complain that exploration activities, together with the movement of equipment and staff to drilling sites, destroy shrubs that nomadic people use to feed their livestock.
- **Environmental protection:** Community leaders express concern over the process for addressing environmental issues. They argue that exploration activities were already underway while the mandatory environmental and social impact assessment was being carried out. The National Environmental Management Authority (NEMA) Act requires that these assessments be conducted prior to the commencement of operations. According to the leaders, community views should have been sought prior to commencement of exploration activities.
- **Employment:** Tullow Oil employs 1400 individuals in Turkana, 57 percent of whom are from the county, accounting (according to Tullow Oil) for 85 percent of the semi-skilled and unskilled workforce.²¹ The local community demands that job allocation should be based on the formula: 70 percent local, 20 percent other Kenyans and 10 percent expatriates. The local community has also requested management positions and scholarships that could develop a skilled workforce from within the county.
- **Procurement:** Community leaders argue that Turkana people are not benefitting from local procurement. For instance, they highlight that the local community received little share from the procurement of a large fleet of vehicles hired by the company. They note that the community is well placed to supply goods and services, such as vehicles, machinery and construction material. They therefore ask that Tullow source 100 percent of these services and goods from local suppliers. The community is currently offering low value services, such as the hire of pick-up vehicles and the supply of unskilled labour. Community leaders would like Tullow Oil to develop procurement policies tailored to the Turkana community and to provide information on tendering opportunities.
- **Corporate social responsibility:** Turkana county is one of the most marginalised regions in Kenya with high poverty and illiteracy rates. Before the forced shutdown, Tullow Oil contributed Ksh 89 million (US\$1,012,160) to corporate social responsibility (CSR) activities in Turkana.²² Community leaders believe that this amount is not proportionate to the needs of the community and the magnitude of the operations. Community leaders want Tullow to contribute more to CSR activities.

20 Turkana County Data Sheet at: <https://opendata.go.ke/facet/counties/Turkana?category=Education&tags=public+finance+revenues+statistical+abstr+act>

21 Mugambi Mutegi, "Tullow now says 57pc of employees are from Turkana region," Business Daily, October 28 2013, at: <http://www.businessdailyafrica.com/Tullow-now-says-57pc-of-employees-are-from-Turkana-region/-/539552/2050134/-/132wojz/-/index.html>

22 Washington Akumu, "Tullow Oil's Woes in Turkana Expose the Soft Underbelly of EA," East African, November 9, 2013, <http://www.theeastafrican.co.ke/business/Tullow-Oil-woes-in-Turkana-expose-the-soft-underbelly-of-EA/-/2560/2066904/-/4jjjr9z/-/index.html>

Mixed Blessing?

Promoting Good Governance in Kenya's Extractive Industries

The Lundin Company, (a partner of Tullow Oil) which holds about a 15 percent interest in the Africa Oil Corporation, which has Block 1, conducted a skills assessment study in 2013 and decided to support a polytechnic in Lodwar, the Lodwar Youth Polytechnic, to provide training of persons to be able to offer semi-skilled services. Plans to support a second polytechnic in Lokori are under consideration.

Tullow Oil resumed operations on 8 November 2013 after entering into a Memorandum of Understanding with the government and local leaders based on consultations with the local community and county officials.

The agreement stipulates that Tullow Oil will establish an office in Lodwar, the capital of the county. The office will have responsibility for working with community leaders on resolving disputes arising from oil exploration, including employment, procurement, and CSR. Tullow also committed to double its CSR allocation from Ksh 89 million to Ksh 178 million per year (US\$2,024,320). The contribution will be made available to the county government to fund appropriate projects identified by the local community.

The agreement is laudable. However, the extent to which the community in Turkana will benefit from oil operations remains limited given the high level technical skills and equipment required in oil drilling operations, compared to the low levels of skills and resources available in Turkana County. Local content is a long term progressive target requiring a multi-pronged approach encompassing not only employment but also different forms of training, entrepreneurship among others, that is heavily supported by regulation and subsequent enforcement.

Key issues such as land use, compensation for land, environmental protection and revenue-sharing²³ among the national and county governments and local communities in oil producing regions, still need to be addressed two years after commercially viable quantities of oil were discovered.

Government responsibility and sustainable development

The national government has a responsibility to ensure that in the future (after exploration stops) people living in the oil exploration areas will still be able to sustain themselves.

It is important that the government, which is the contracting party in the PSC exercised by the oil drilling companies, be part of community engagement and any community development programmes created by either the oil companies, the county government or the various NGO players in the extractive industries arena.

Indeed, the national government should play an active coordinating role, particularly as several national government agencies will be actively involved when the production phase starts. These include agencies managing security, pollution, safety, environment, hygiene and health, disaster management,

²³ Kenya's "Final Draft of the National Energy Policy" of March 2013 and the Energy Bill both propose that 80% of the petroleum revenues go to the national government, 15% to the relevant county, and 5% to the community where the resources are extracted. However, this proposal has not yet been put in place.

the drilling authority, data collection, communication systems, air control and flight management, and personnel and training at both county and national level.

Leaving oil companies to deal directly with communities is not sustainable as an investor policy. A clear framework for sustainable community development and local content, specifying the minimum amount, should be created. The role of the county government in this should be clearly defined and incorporated in the county development plan. This means that oil companies are treated as a local stakeholder at county level. Oil companies will then be at liberty to carry out their own social responsibility projects, above the set minimum, at their own discretion.

4. Best practices to promote good governance and address corruption in the oil sector

Best practices are representative of methods, techniques or action that have been proven through practice to be the most effective, or the most appropriate, in addressing specified situations. They are preferred because it is believed that their application would lead to the most desired results in certain situations, especially in comparison to other possible methods, techniques or action.

In the extractive industry best practices address the need to entrench transparency, accountability and public participation in the industry, including reporting on revenues and dealing with noncompliance on laws and regulations, oversight mechanisms, open contracting and others.

Sustainable development is commonly described as meeting the needs of current and future generations.²⁴ In other words, the development choices made today should not be at the expense of future generations and the planet. For the purpose of this brief it therefore refers to the simultaneous pursuit of sustained environmental protection, economic growth and equitable distribution of wealth, alongside the development of the petroleum sector in Kenya - issues that Kenya should be aware of while exploiting oil.

Some of the best practices in the oil extractive sector as applicable to the Kenyan situation are discussed below:

- The Extractive Industries Transparency Initiative (EITI)
- The Natural Resource Charter (NRC)
- Establishment of a sovereign fund (including its management) with public and civil society oversight.
- Open tendering
- Transparency in PSC contracting

²⁴ See "Report of the World Commission on Environment and Development: Our Common Future (Brundtland Commission)," United Nations, 1987, at: <http://www.un-documents.net/wced-ocf.htm>

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- Public sharing of PSCs and revenue streams
- Revenue collection, management and distribution using public and civil society involvement and oversight
- Revenue sharing.

The Extractive Industries Transparency Initiative

The Extractive Industries Transparency Initiative (EITI) is a global coalition of governments, companies and civil society organisations working together to improve transparent and accountable management of revenues from natural resources. The EITI standard contains the requirements countries must meet in order to be recognised as first, an EITI candidate, and ultimately an EITI compliant country.

The EITI process recognises that natural resources, such as oil, gas, metals and minerals, belong to a country's citizens. Therefore the EITI has transparency and citizen oversight at its core. (See Annex II.)

Natural Resources Charter

The Natural Resources Charter is a global initiative active in the African Union. The Charter provides twelve precepts to inform and improve natural resource management. Ten of these offer guidance on core decisions that governments face – beginning with the decision to extract the resources, and ending with decisions about using the revenues they ultimately generate. The other two are addressed to important actors and their responsibilities. (See Annex II for more details and other initiatives that it would be useful for the government, civil society and citizens to consider.)

Nigeria was the first country assessed against the Charter when they did a pilot NRC benchmarking exercise.²⁵

Sovereign Fund

A sovereign fund, as proposed in the draft Energy Bill and the Mining Bill, allows a country to save revenues collected for future generations. It also helps ensure macro-economic stability by controlling the amount of oil money injected into the economy at any given time.

Other key advantages of a sovereign fund are that it helps to maintain balanced national development and to manage the impact of low commodity prices on the economy.²⁶ For a sovereign fund to work well, it requires the creation of transparent systems for allocating, depositing and withdrawing revenues. Norway, Ghana and Trinidad and Tobago possess some of the best-managed sovereign funds in oil-producing countries.

²⁵ Results can be viewed at <http://naturalresourcecharter.org/content/nigeria-assessment>.

²⁶ Article 162 of the Draft Energy Bill proposes the establishment of a sovereign fund of similar objectives.

Table 1. Trinidad and Tobago Sovereign Fund

Heritage and Stabilization Fund (Trinidad and Tobago)

The Heritage and Stabilization Fund (HSF) was established with the passing of the HSF Act. No. 6 in March 2007.

Objectives of the Fund

The purpose of the Fund is to save and invest surplus petroleum revenues in order to: cushion the impact on or sustain public expenditure capacity during periods of revenue downturn whether caused by a fall in prices of crude oil or natural gas; generate an alternative stream of income so as to support public expenditure capacity as a result of revenue downturn caused by the depletion of non-renewable petroleum resources; and provide a heritage for future generations of Trinidad and Tobago, from savings and investment income derived from excess revenues.

Deposits to the Fund

Where petroleum revenues collected in each quarter of any financial year:-

- Exceed the estimated petroleum revenues for that quarter of a financial year by more than ten percent (10%), the currency of the United States of America equivalent of the excess revenue shall be withdrawn from the Consolidated Fund and deposited to the HSF; or
- Exceed the estimated petroleum revenues for that quarter of a financial year but do not exceed such estimated revenues by at least ten percent (10%), the Minister may direct that the currency of the United States of America equivalent of all or part of the excess revenue shall be withdrawn from the Consolidated Fund and deposited to the HSF.

Withdrawals from the Fund

Where the petroleum revenues collected in any financial year fall below the estimated petroleum revenues for that financial year by at least ten percent (10%), withdrawals may be made from the Fund as follows, whichever is the lesser amount: either sixty percent (60%) of the amount of the shortfall of petroleum revenues for that year; or twenty-five percent (25%) of the balance standing to the credit of the Fund at the beginning of the year.

Corporate Governance

The President shall appoint a five member Board with proven competence in the fields of finance, investment, economics, business management or law, including an officer of the Central Bank and the Ministry of Finance. The Board shall determine the governance structure and the operational and investment guidelines of the Fund. The Central Bank will have the responsibility for the management of the Fund. Transparency and accountability is also provided through the submission of quarterly reports to the Board on the holdings, performance and risk of the Fund, as well as the submission of an Annual Report of the Fund together with the audited, financial statements and investments report on the performance of the Fund.

Source: Ministry of Finance and the Economy, Trinidad and Tobago (2013)²⁷

²⁷ See the Heritage and Stabilization Fund, Ministry of Finance and the Economy, Trinidad and Tobago at: <http://www.finance.gov.tt/legislation.php?mid=20>

Environmental protection

Petroleum operations pose considerable environmental challenges, which also encompass health and safety risks. These include managing land sustainably, protecting the atmosphere, conserving biological diversity and protecting and managing the ocean, as well as fresh water. Other challenges include the safe use of toxic chemicals and managing hazardous wastes and gas flaring. Oil production is also a major contributor to greenhouse gas emissions, such as carbon dioxide, as a result of the methods of drilling used to obtain the oil. These emissions lead to climate change.²⁸

When oil production starts, Kenya will face all of the above environmental challenges. Addressing them requires the development and strict enforcement of national environmental laws and regulations specific to the petroleum sector. There must also be active, continual and sustained cooperation, as well as regular dialogue among the oil companies, government regulatory agencies, civil society groups and the local community on addressing the environmental challenges.

Current framework: Neither the Petroleum (Exploration) Act Cap 308, nor the Model Production Sharing Contract (PSC) impose specific environmental protection obligations on contractors in oilfields.

However, the Draft Energy Bill, 2014 while being general in its main section (153) on environment protection, gives the cabinet secretary wide powers to regulate a host of specific environmental issues that would occur in oil exploration and production.

The environmental footprint of drilling and production operations for oil and gas projects is variable and depends on the operator's equipment, operational needs and objectives. Therefore countries like USA, UK, Australia and Norway have drilling and production regulations and best practices. These are published by organizations such as the American Petroleum Institute, the Department of Energy and Climate Change, the Environmental Protection Authority (onshore), the National Offshore Petroleum Safety Authority (offshore) - the last three all Australian, and the Norwegian Petroleum Directorate. The latter does this in close liaison with the Safety Authority Norway and the Norwegian Climate and Pollution Agency.

The effectiveness of such institutions should not be underestimated. For example, roads need to be constructed to support various exploration and production operations. The American Petroleum Institute (API), recognising that the environmental impact of the construction of a roadway can have lasting effects well beyond the limits of the right-of-way, has developed 'API Recommended Practice 51R 2009' explaining how existing roads should be utilised, where feasible, to limit the extent of new road construction, when they meet regulatory standards, transport and development needs, and safety and environmental objectives. When it is necessary to build new roadways, they should be developed in an environmentally acceptable manner consistent with landowner and community recommendations.

28 Dr. Alaa A. Bukhari, "Sustainable Energy and Environment: Objectives, Challenges, the Needs and the Road Map," February 2013, at: <http://www.jccp.or.jp/english/wp-content/uploads/25jccp-dr-bukhari-presentation-feb-5-2013.pdf>

Example 1: Chad Oil Project road highway

The Chad-Cameroon oil pipeline has been operational for over six years, but the controversy surrounding the so-called oil for development project has not yet died down today, in 2014. More than 300 kilometers of the pipeline's path cuts through the equatorial rainforest, ancestral home to the Bagyeli, one of Cameroon's indigenous, 'pygmy' groups. The rainforest passage was one of the most controversial aspects of the pipeline project; many environmental and civil society organizations feared that disruption of the region's ecosystem would adversely impact on the Bagyeli's already fragile existence. The Chad Oil Project, in addition to the government, includes three private partners, ExxonMobil, Petronas and Chevron.

Example 2: Papua Guinea Pipeline Project

In Papua New Guinea, a pipeline from the Gobe oil fields cuts through forest land and small farms. Roads built to service the project are opening frontier forests to timber companies, increasing the threat of soil erosion that will load the rivers with silt and kill the country's offshore coral reefs.

UK Licensing policy

In the UK,

- Licences would only be awarded where the potential licensee shows his commitment to the use of British suppliers
- Prior actions will be taken into account
- Ministerial approval for development plans require a demonstration of efforts taken to ensure maximisation of British content.

Norway - Statoil (Norwegian State Oil Company)

- Joint Operating Agreements require Norwegian companies to be included in all requests to bid and that Norwegian services should be used if competitive
- Statoil held 51% in each committee and actively used its voting power to influence the appointment of Norwegian suppliers
- A goods and service office was created by law and Norwegian companies to be chosen if competitive
- Licence awards were influenced by prior practice
- Detailed legal provisions in relation to research & development - 50% to be conducted in Norway.

LOCAL CONTENT IN NIGERIA

The Nigerian Government has set a minimum local content target of 75% by 2010 for all works and contracts to be undertaken in or on behalf of all oil and gas companies operating in the Nigerian oil and gas industry. This target is fully supported by the oil and gas companies operating in Nigeria.

To meet this target a number of processes are now in place including a contract evaluation and award criteria which favour bids that meet or exceed the minimum local content target. The Nigerian Government, via the NCD (Nigerian Content Division) of the Nigerian National Petroleum Corporation, has issued a list of 23 categories of work which must be executed in Nigeria.

Paragraph 37, Schedule 1 of the Petroleum Act provides that within 10 years of granting an Oil Mining Licence (operating licence):

- Nigerians in managerial, professional and supervisory grades in connection with the lease must be 75% of total staff
- Nigerians in any one grade must not be less than 60 per cent of the total
- All semi-skilled and unskilled workers must be citizens of Nigeria.

These are critical institutions that Kenya needs to establish urgently. The Draft Energy Bill does not specifically recognise the need for separate environmental, safety and pollution organisation(s) for the upstream oil sector with the pre-requisite technical competence to manage the sector. Instead the authority has been ceded to the Cabinet Secretary, Ministry of Energy and Petroleum.

It should be recognised in the planning stage that road alignment and right-of-way selection is a multidisciplinary process. Planning goals should include affected resource values and safety, and avoidance of haphazard or unnecessary development of roads and associated utility corridors. The total infrastructure that may later be developed should be considered during the selection process. Government agencies, landowners, tenants, and other users will need to be consulted during the planning process.

Economic growth

In addition to effective and efficient use of taxes collected from the oil sector, economic growth can be pursued by developing local content and establishing a sovereign fund (see page 14).

Creating local content, which is best realised through a distinct policy and law, allows businesses in the host country to participate in activities across the petroleum value chain.²⁹ The local companies can also add value to oil in Kenya and produce petroleum by-products such as jet fuel, diesel fuel, heating oil, asphalt, tar, paraffin wax and lubricants. As local companies are major sources of employment, their effective participation in the sector has a direct impact on improving the lives of local communities.

It must be noted however, that the key driver of oil exploration is to monetise production as fast as possible to allow investors to recover their costs and provide them with a return as soon as possible; the host government would also want to see monetary returns and cash in the national treasury to provide income to meet national needs. In this regard, the provision of energy is secondary, as importing may still be cheaper in the medium term. Investing in a refinery would be a separate major investment and not part of a PSC requirement. Refinery investment decisions are complex, as it is a multi-million dollar investment driven by market demand. The expected volume of oil from Kenya alone would not, at this point, justify the building of a refinery for fuel products in Turkana, particularly given Uganda's decision to build one. Perhaps putting up a petrochemical plant would be viable, but this would also be based on crude oil production quantities.

In order for local content to succeed, a number of requirements must be met. These include a skilled workforce, training for local companies and staff, an investment-friendly environment, transparency, an open and fair tendering process and programmes that promote the development of small-scale enterprises.

²⁹ Article 11 of the Petroleum Act implies obligations for contractors to source locally available goods and services and to give preference to Kenyan nationals in training and employment. Article 163 of the Draft Bill also requires local content participation of Kenyans in the petroleum sector. However, Kenya does not yet have a dedicated and detailed policy and law on local content.

Other key requirements are to establish dedicated capacity to promote and monitor local content, and legislation requiring international oil companies and service providers to form partnerships with local businesses and institutions. The partnerships would facilitate the transfer of technology and know-how.

In the late 1970s, for instance, Norway required applicants for licences to conduct 50 percent of their research relating to Norwegian operations in Norway.³⁰ The requirement facilitated technology agreements between oil companies and Norwegian research and development institutions. This in turn translated into Norway developing petroleum technology, which resulted in the participation of many local companies in the oil sector.

Equitable wealth distribution

Petroleum production generates significant revenues for the government. Empirical evidence in sub-Saharan Africa shows that oil revenues are not equitably shared within society. Elites or special interest groups take control of the revenues through the government, leaving the economic interests of the wider society unaddressed. As seen in the cases of Chad, Nigeria and Congo Brazzaville, inequalities emanating from inequitable distribution of oil wealth lead to suppression of critics, human rights abuses, political violence and instability. A key antidote to ensuring that oil does not become a destabilising force is to create a fair wealth-sharing mechanism backed by strong governance, transparency and accountability systems.

Public consultation

Oil can be a catalyst for economic development, but it can also bring human misery. However, public consultation can mitigate the negative impacts of oil exploitation. Not only does it promote transparency, but it also provides feedback to decision makers on the development of policies and laws relating to the exploitation of oil. In the lead-up to the enactment of its Petroleum Revenue Management Act (2011), Ghana conducted a countrywide public consultation on the collection, spending, saving, budget allocation, accountability and transparency of oil revenues.³¹ In 2012, the National Oil Company of Liberia launched a national consultation on oil policy to seek the views of civil society representatives in all of Liberia's counties.³² Kenya has not undertaken public consultations of the same scale on the revisions to the Petroleum Act. Under the EITI and the Natural Resource Charter, this would be mandatory.

30 Al-Kasim, Farouk, *Managing Petroleum Resources - The Norwegian Model in a Broad Perspective*. (Oxford: Oxford Institute for Energy Studies, 2006).

31 Joe Amoako-Tuffour, "Public Participation in the Making of Ghana's Petroleum Revenue Management Law," November 2011, at: <http://naturalresourcecharter.org/sites/default/files/Ghana%20Public%20Participation.pdf>

32 Ben Shepherd, "Oil in Uganda: International Lessons for Success," February 2013, at: http://www.chathamhouse.org/sites/default/files/public/Research/Africa/0113pr_ugandaoil.pdf

Licence transparency

Kenya does not publish details of licences awarded to oil companies. The process of awarding licences to explore and exploit oil can be subject to corrupt practices if it is not conducted in an open and transparent manner. Given this possibility, the EITI, which helps reconcile company payments and government receipts, now requires implementing countries to disclose information related to the award or transfer of licences for oil, gas and minerals. Implementing countries must provide the following information in their EITI reports:

- a description of the process for transferring or awarding the licence
- the technical and financial criteria used
- information about the recipient(s) of the licence that has been transferred or awarded, including consortium members where applicable
- any major deviations from the applicable legal and regulatory framework governing licence transfers and awards.

Implementing countries must also maintain a public register containing issued licences. The EITI and the Natural Resources Charter also encourage disclosure of beneficial ownership of the licences, an additional and desirable safeguard against corruption.³³

Contract transparency

Oil contracts in resource-rich countries, which refer to concessions, PSCs or other agreements granted by, or entered into by the government, are often shrouded in secrecy. Kenya is no exception and has yet to make public PSCs signed with oil companies.³⁴ Confidentiality clauses prevent the disclosure of contracts to local stakeholders. Governments and companies argue that contracts include commercially sensitive information that cannot be disclosed publicly. In doing so, they refer to the financial and technical data of the project as confidential, and exclude these from contracts which they are obliged to disclose, but include them in other documents which they are not obliged to disclose.

Contract transparency is very important for the public in that citizens can hold governments accountable for protecting the public interest. They can also hold governments and companies accountable to the terms of the agreements they sign. The disclosure allows citizens to ensure that payments agreed are made, that the environment is protected and that obligations to the local community are met. Contract transparency gives citizens a platform to engage in discussions with governments and companies in a meaningful way. The absence of contract transparency makes it difficult for citizens to conduct a dialogue with governments and companies on issues of concern, given the resultant information asymmetry.

³³ The EITI Standard, July 2013, at http://eiti.org/files/English_EITI%20STANDARD_11July_0.pdf

³⁴ See Part viii on Confidentiality of the Model PSC at: http://nationaloil.co.ke/pdf/sharing_contract.pdf

Contract transparency is emerging as a norm, as more and more countries embrace the practice. A number of countries, such as Azerbaijan and Yemen, require their parliaments to ratify oil contracts. Thanks to an EITI Bill, Liberia Extractive Industries Transparency Initiative publishes contracts on its website (www.leiti.org.lr/). In addition, the EITI requires implementing countries to disclose contracts on oil, gas and minerals.³⁵

Revenue transparency

Oil producing countries collect considerable funds from extractive companies, including licence fees, royalties, dividends, taxes, and, in some cases, in-kind payments (such as crude oil). A key mechanism for ensuring transparency is through the EITI standard, which is implemented by 41 oil, gas and mineral producing countries. Kenya has not yet joined the EITI but, as earlier mentioned, is considering joining.

EITI helps the publication of company payments and government revenues from the extractive sector. Implementing governments must commit to:

- the transparency requirements of the initiative
- appointing a senior representative to lead the EITI in the country
- establishing a multi-stakeholder group consisting of representatives from government, industry and civil society
- producing an annual report compiled by an independent third-party, which reconciles company payments and government revenues from the extractive sector.

Governments that fulfill the EITI's transparency standards become EITI compliant countries.

The EITI provides space to monitor revenue transparency by the government, industry and civil society and facilitates the flow of information to the public concerning revenue collection from the extractive sector. The EITI process brings a tangible financial benefit to implementing countries.

In Nigeria, for instance, the EITI helped the government recover approximately US\$442 million. The amount is part of US\$2.6 billion owed to the government by oil and gas companies operating in the country between 1999 and 2008.³⁶

National oil company accounts

Research by Transparency International in 2011 found that national oil companies (NOCs) do not publish their accounts in line with internationally or generally accepted accounting standards, particularly those that are not listed in the stock market. Some do not reveal the standards they use, while others do not undergo independent auditing. The research revealed that even when NOCs publish their financial

³⁵ The EITI Standard.

³⁶ See Transparency at: <http://www.one.org/international/issues/transparency/>

and operating reports, it becomes difficult to judge the quality and comparability of the data against international standards.³⁷ A good practice would be for a NOC to introduce internationally or generally accepted accounting standards and to commission an independent audit of its accounts. As a state-owned company, NOCK is audited by the National Audit Office and its accounts tabled to Parliament. This means that as a government-owned company the accounts are publicly available.

Budget transparency

Oil-rich countries use some of the generated revenues to finance the national budget. However, the budget process is opaque in many oil-producing countries. The International Budget Partnership, which produces the Open Budget Index (OBI), a comparative measure of the accessibility and comprehensiveness of critical budget information, found that oil and gas producing countries are less transparent in this domain compared with other countries.

According to the 2012 OBI, Kenya scored 49 out of 100 while the best performer in Africa was South Africa with a score of 90 out of 100 and the worst in Africa was Equatorial Guinea with a score of 0 out of 100.³⁸ Budget transparency allows citizens to find out how much of the oil revenues are brought into the government budget and how the money will be spent. The openness of budget information helps the government and the public to set agreed priorities on spending the revenues collected from oil operations.

Parliamentary oversight

Parliament can play a crucial role in the management of oil resources. Parliamentarians can design management systems that put a country on the right path and mitigate risks associated with oil. In the 1960s, when oil was found in Norway, its Parliament ensured a proper management of the resource ensuring transparency and oversight over oil production, decisions made regarding oil production and use and saving of oil revenues for future use.

Parliamentarians in Africa face a number of challenges in playing this role. Weak institutional capacity, powerful executive branches and ruling parties, and a lack of political will often prevent parliamentarians from taking an interest in the extractive sector. The technical complexities of the sector also contribute to the lack of active parliamentary oversight.³⁹ The Kenyan Parliament is not actively playing its oversight role, given its preoccupation with the devolution of power from the national government to the counties under the new Constitution. The Parliament has yet to update key legislation governing the sector.

37 "Promoting Revenue Transparency: 2011 Report On Oil And Gas Companies," Transparency International, March 1, 2011, at: http://www.transparency.org/whatwedo/pub/promoting_revenue_transparency_2011_report_on_oil_and_gas_companies

38 According to the OBI, 0-20 means scant or none; 21-40 minimal; 41-60 some; 61-80 substantial; and 81-100 extensive. For details on Kenya's score see: <http://internationalbudget.org/wp-content/uploads/OBI2012-KenyaCS-English.pdf>

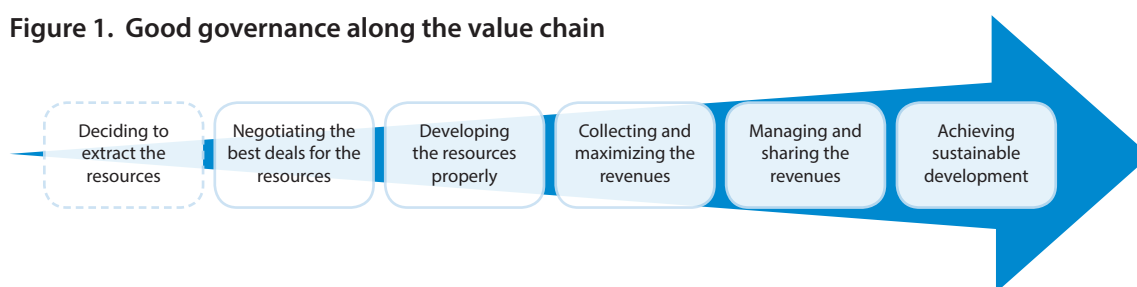
39 Shari Bryan and Barrie Hofmann, "Transparency and Accountability in Africa's Extractive Industries: The Role of the Legislature," National Democratic Institute for International Affairs, 2007, at: http://www.ndi.org/files/2191_extractive_080807.pdf

At the time of writing this report, the Energy Bill was yet to be presented to Parliament. Cabinet Secretary for Energy and Petroleum Davis Chirchir said that his ministry aimed to have the law approved by October 2014.⁴⁰

The new Energy Bill lists new guidelines on natural gas exploitation, allows for the creation of a sovereign wealth fund to save some revenue and specifies how local communities will benefit.⁴¹

Parliamentary oversight of each stage along the extractive sector value chain is crucial to advancing good governance and combatting corruption. Thus Parliament must oversee the decision to extract, the awarding of contracts, actual extraction operations, revenue collection and revenue expenditure (see Figure 1 below). Oversight tools available to parliamentarians include using the question and answer period, holding committee hearings, requesting documentation from the government, making use of the parliamentary ombudsman office and holding debates. The new constitution requires public participation in the work of Parliament, which must therefore reach out to include the public in oversight of the extractive sector through various means such as open hearings, public broadcasts, the acceptance of written submissions and expert opinions.⁴²

Figure 1. Good governance along the value chain



Source: World Bank Institute (2008)⁴³

Corruption in the extractive sector often begins at the contracting stage. Given this risk, parliamentary involvement at this stage is critical. In Liberia, Parliament ratifies oil contracts after they are negotiated and signed by the Minister of Lands, Mines and Energy. In Kenya’s draft Energy Bill, parliamentary approval of PSCs is now required.

The role of the National Audit Office

The National Audit Office has the mandate to audit government operations and accounts. It provides Parliament with independent information, advice and assurance regarding government’s management

40 By the end of October 2014, the draft Energy Bill 2014 had not been presented before parliament

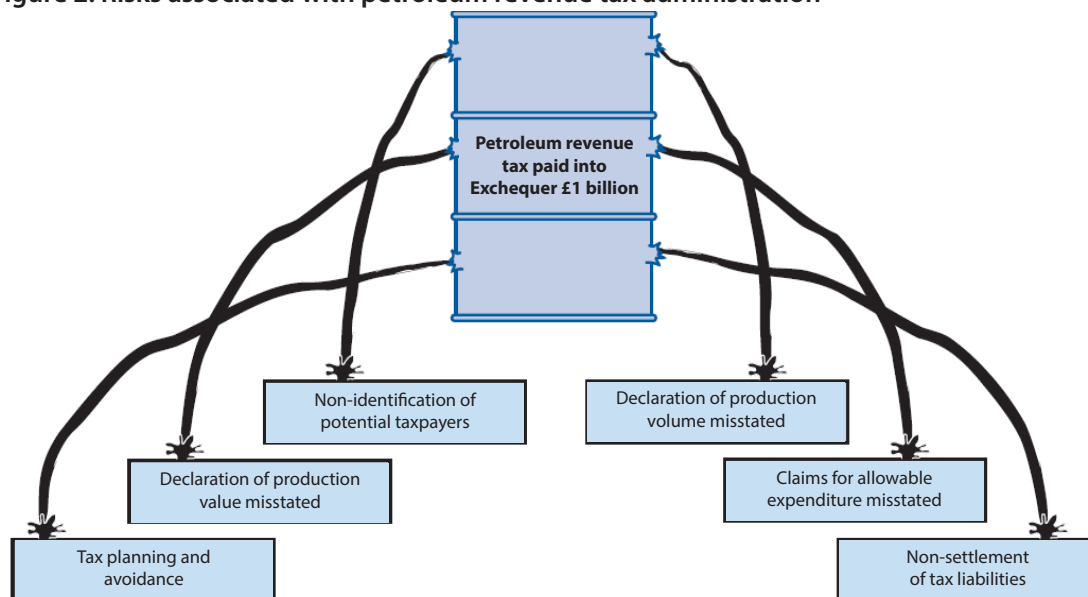
41 “Parliament to approve new energy bill before end of year” Kenya Engineer, Thursday, 26 June 2014; (Available at: <http://webcache.googleusercontent.com/search?q=cache:Ngf1NKEMzDMJ:www.kenyaengineer.co.ke/index.php/n-e/ln/2108-parliament-to-approve-new-energy-law-before-end-of-year+%cd=9&hl=en&ct=clnk&client=firefox-a>; accessed: 18/07/2014). The bill also provides for the creation of a detailed National Energy Policy (NEP).

42 See, “Public Participation and Parliamentary Oversight - Legal Reforms and Policy Options,” AfriCOG, September, 2012. Available at <http://www.africog.org/content/public-participation-and-parliamentary-oversight-legal-reforms-and-policy-options>

43 “Parliamentary Oversight of the Extractive Industries Sector,” World Bank Institute, 2008, at: http://www.agora-parl.org/sites/default/files/parliamentary_oversight_and_the_extractive_industries.pdf

of public funds. In some oil producing states, in addition to auditing government agencies involved in the sector, the office also scrutinises financial information provided by oil companies to ensure that the government recovers due revenues. In the UK for instance, the National Audit Office undertakes a yearly audit of petroleum revenue tax and corporate tax receipts. From time to time it also examines how the UK's taxation office manages the risks associated with revenue collection from the oil companies. Key risks are described in the following figure:

Figure 2. Risks associated with petroleum revenue tax administration



Source: UK National Audit Office (2000)⁴⁴

In Kenya, the National Audit Office audits the accounts of NOCK and the Ministry of Energy and Petroleum. However, in order to play a meaningful role, the National Audit Office needs to bolster its capacity to audit or oversee financial accounts relating to petroleum operations.

Monitoring and taxation capacity

A key challenge facing resource-rich countries in Africa is the absence of capacity to monitor production of resources. As a newcomer to resource extraction, Kenya would face the same challenge. This weakness robs governments of tax revenues.

The operations carried out by upstream oil companies are broadly classified into acquisition, exploration, development and production. A government must have a dedicated body that monitors expenditures incurred under each of these activities.

⁴⁴ See "Inland Revenue: Petroleum Revenue Tax," National Audit Office, December 2000, at: <http://www.nao.org.uk/report/inland-revenue-petroleum-revenue-tax/>

Costs incurred in acquiring the right to explore, drill and produce oil include a lease bonus, brokers' fees, legal costs and compensations paid to landowners. Key exploration and appraisal costs include geological and geophysical expenses, salaries, well tests, property taxes and depreciation of equipment. Development expenses include costs incurred in drilling, clearing the ground, drainage and building roads; equipping development wells; acquiring, constructing and installing production facilities; and providing improved recovery systems. Production costs encompass labour, repair and maintenance, expenses to operate wells and equipment, production taxes such as royalties, support facilities and equipment, repair and maintenance, supplies, fuel and insurance on property.⁴⁵

In Norway, the Oil Taxation Office (OTO) under the Ministry of Finance is responsible for the tax assessment of all oil exploration, production, and transport companies. It has more employees per tax payer than any other assessment office in Norway. OTO's staff includes economists, tax accountants, lawyers and industry specialists. OTO carries out its work by examining tax returns and additional correspondence with industry taxpayers. It may also carry out field audits in the offices and facilities of the tax payer. OTO is empowered by a robust Norwegian taxation law. Taxpayers that submit incorrect or insufficient information may face a penalty of 30 percent of the tax. When a tax payer does this willfully or with gross negligence, the penalty rate may increase to 60 percent.⁴⁶

Independent oversight

Citizens' groups have a key role to play in overseeing the management of oil revenues through the establishment of an independent oversight mechanism, which Kenya currently lacks. This mechanism would provide a systematic and objective review of the sector, specifically by addressing failures to comply with existing laws.

Under the provisions of the Petroleum Revenue Management Act (2011), Ghana created the Public Interest and Accountability Committee (PIAC)⁴⁷ consisting of 13 members drawn from organised professional bodies, think tanks, pressure groups and traditional institutions, among others. PIAC monitors compliance with the Act by the government and other institutions and provides an independent assessment of petroleum production and receipts. It also serves as a platform for public debate on how petroleum revenues are spent. Under the Act, PIAC publishes a semi-annual and an annual report by 15 September and 15 March each year.

Freedom of information laws

Public access to information about the oil sector in many resource-rich countries remains a major challenge. The public cannot access information that impacts on communities, such as reports on the

45 C.A. Satyavati Berera, "Technical Guide on Internal Audit in Upstream Oil and Gas Companies," The Institute of Chartered Accountants of India, June 2007, at: <http://220.227.161.86/21005upstreamoilgas.pdf>

46 Jan B. Jansen & Bjerke, Joachim M. Bjerke, "An Introduction to Norwegian Petroleum Taxation," February 2012, at: <http://www.bahr.no/en/news-and-events/archive?index=20>

47 See Article 54 of the Act at: <http://ghanaoilwatch.org/images/laws/petroleum-revenue-management-act815-2011-.pdf>

environment filed by companies. Freedom of Information Laws (FOIs), which Kenya has not yet enacted, facilitate public access to information and transparency in government. FOI laws address the culture of secrecy that often surrounds sector information, such as licences, ownership and contracts. In oil-rich countries such as Canada, the public can access such information under FOI legislation.

5. Recommendations for entrenching best practices in the governance of the oil sector in Kenya

These recommendations are based on the best practices discussed, including how to ensure that the local communities are protected and that they benefit appropriately, focusing on necessary legal and institutional mechanisms and the relationships between the two.

The following are key issues involved in building the confidence of the Kenya public in the government's ability to manage the extractive industry, and in particular oil, on the people's behalf.

Communication

- **Good communication is crucial.** The public and civil society (as well as the country's partners and donor community) are frustrated because the government is not communicating effectively and openly about its plans for the oil industry. It has yet to embrace the new constitution that demands citizen participation in the determination of Kenya's future.
- **A public platform provided by the extractive sector is key.** It should promote knowledge and evidence-based stakeholder dialogue on the sector in Kenya to facilitate informed policy debate. Thus, an 'Information Centre for the Extractive Sector' (ICES) was launched in December 2013 at the Nairobi iHub (an open space for technologists, investors, tech companies and others). The centre is supported by development partners.⁴⁸
- **Develop a vision.** Prior to the discovery of commercial quantities of oil in Turkana in 2012, the extractive sector was not a priority sector for the Government of Kenya. However, attitudes have shifted and the extractive industry is now the seventh sector under the economic pillar of Vision 2030. As earlier mentioned, oil is forecast to be the major GDP earner in four to seven years. Kenya urgently needs a vision that addresses and responds to the high-level strategic question: how does Kenya avoid the resource curse and Dutch disease? A coordinating mechanism in the Office of the President should be created and, as a first task, establish a series of national conferences and think-tanks to develop a vision and accompanying roadmap for the extractives sector. The communication centre will then communicate the vision.

48 <http://ices.or.ke/>

Community development

A community development programme should be created and implemented as soon as possible. There is palpable frustration, bordering on anger, at a lack of engagement with the local community. Traditional dry-season grazing areas were fenced off without adequate communication or community consent. Expectations for providing water solutions, education and jobs for local communities ran high. While in the south of Kenya, community issues over compensation claims for titanium mining were finally resolved and a first export shipment made in February 2014, there is still opacity on revenue collection, management and distribution. In the case of Turkana it is clear that the urgent issues are security and water.

As substantial water reserves have been discovered in Turkana County and the technology for constructing water pipelines and crude oil pipelines is similar, technical assistance in drilling and building an extensive network of water pipelines can be provided by the oil companies under a loan system.

Integrity and capacity building

Transform the capacity and integrity of leading institutions overseeing the oil sector, even as new institutions are set up. If well run by people of integrity using technical knowledge, they can ensure that the positive benefits of oil production will flow down to the people of Kenya, and in particular to the communities around the extractive industries. The following institutions are critical to the success of oil management: Ministry of Energy and Petroleum, National Oil Corporation, Kenya Pipeline Company, Kenya Revenue Authority, National Treasury, Department of Planning, Ministry of Environment, National Environment Management Authority, Office of the Attorney General, State Law Office, Commission on Revenue Allocation, Office of the Controller of Budget, Ministry of Labour, National Fossil Fuels Advisory Committee, Ministry of Industrialization and Enterprise Development, Vision 2030 Secretariat and security agencies amongst others.

A project by donors, coordinated by DFID and run by Adam Smith International (see Section 1) is attempting some of the work, as indeed are the World Bank and IMF who have proposed support programmes that are under discussion. However, it is essential for the Kenya Government to establish, together with stakeholders, what they envision for the industry. This can then be followed by engagement with multiple development agencies and governments who have flocked to 'support' or 'assist' Kenya, but are only driven by their own interests.

Recommendations to stakeholders

Kenya is at a critical juncture in managing its new-found oil resources and has the opportunity to put in place mechanisms that ensure its people, both today and in the future, benefit from them. The following recommendations are proposed to ensure that the discovery of oil is a blessing for all Kenyan people.

To the Government of Kenya

- As development of new petroleum laws continues, involve the public and seek their views on key issues on the governance of the oil sector, including environmental protection, revenue collection, sharing, spending, saving, accountability, transparency and budget allocation.
- Enhance the Kenya Revenue Authority's capacity by creating a dedicated oil taxation office with strong technical capacity for monitoring, tax assessment and collection from oil production companies in Kenya.
- Join the EITI and publish all revenues collected from oil companies in Kenya, including details on licences, information on awarding and transferring petroleum licences, contracts, information on oil revenues collected and monitoring of where and how the revenues are allocated, amongst other requirements under the EITI framework.
- Before exploration activities begin, establish a dialogue mechanism between all parties including county and national governments and address local community concerns such as land use, compensation for land, and environmental protection.

To Parliamentarians

- Review the new Energy Bill to ensure that modern best practices in oil revenue collection and management as espoused by EITI, the Natural Resource Charter and others, are included. For example:
 - parliamentary approval of oil contracts
 - establishment of a sovereign fund.
- Pass the Freedom of Information Bill to allow public access to information on tendering, contracting, revenue collection and so on, in line with the Open Government Partnership principles to which Kenya is a signatory.
- Obtain information on the extractive industries and case studies on 'Lessons Learnt', (Nigeria, Equatorial Guinea, Gabon, Chad) as well as 'Best Practices' (Botswana, Ghana, Nigeria, Norway, Australia), as the sector is forecast to be the largest GDP earner in the next 3 to 5 years.

To oil companies

- Engage the local community and link with county and national governments for a sustainable resolution of issues.
- Establish a good governance standard with agents contracted to liaise and implement social responsibility projects with the local community.

To local communities

- Seek knowledge and information on budgetary allocation from oil revenues and engage county officials on spending.
- Participate in monitoring oil revenues by all parties – by reviewing information from county and national governments, the community and NGOs working on extractive sector issues.
- Recognise oil companies as investors and not as an alternate 'government' to provide services.

To civil society

- Promote EITI and lobby the government to sign up to it.
- Engage Parliament in developing effective legislation.
- Participate in the monitoring of oil revenues.
- Educate the public and media on the benefits and ills of extractive industries.
- Build capacity in a vigorous and aware civil society to act as a watch dog.

Annex I: Legal and Institutional Framework

Oil exploration in Kenya – legal and institutional framework

Key laws governing the oil sector include the Constitution of Kenya 2010, the Petroleum (Exploration and Production) Act, Chapter 308 of the Laws of Kenya 1986 (the Petroleum Act), regulations made under the Petroleum Act and the Ninth Schedule to the Income Tax Act, and Chapter 470 of the Laws of Kenya 1974.⁴⁹

The 2010 Constitution vests the ownership of natural resources in the central government.⁵⁰ These are held in trust for people of Kenya who have sovereign power. The Constitution provides for the establishment of the National Land Commission (NLC), which is constituted under the National Land Commission Act (May 2012). The NLC is assigned the role of administering Kenya's oil and mineral resources on behalf of the people of Kenya who have sovereign power.⁵¹

The Constitution states that the Kenyan Parliament must ratify grants of rights or concessions regarding the exploitation of natural resources. However, this requirement does not come into effect until Parliament passes further legislation. Parliament must enact the legislation by August 28, 2015, five years after the effective date of the 2010 Constitution. The requirement of parliamentary approval would likely apply to future rights and concessions, not those that had already been signed before the promulgation of the constitution.

The Petroleum Act regulates activities relating to the exploration and production of oil in Kenya. Under the Act, the Minister of Energy and Petroleum has the authority to divide Kenya and its continental shelf into blocks. The Act prohibits the involvement of petroleum operations without the minister's permission. The Act requires the government to conduct petroleum operations either through the National Oil Corporation of Kenya (NOCK) or through licensed private contractors.

49 Also refer to The Mining Bill, 2014 which by the time of publishing this report, had been passed by Parliament and was awaiting Presidential assent.

50 See Article 69 of the Constitution of Kenya (2010) at <http://www.kenyaembassy.com/pdfs/The%20Constitution%20of%20Kenya.pdf>

51 National Land Commission Act, 62 (3) (f).

International oil companies operate under a Model Kenyan Production Sharing Contract (PSC), in which the government can participate through NOCK.⁵² The Model PSC is also used as a basis for conducting negotiations. PSCs have been signed with a number of oil companies.⁵³ The Model PSC requires companies to give 25 percent of their block back to the government after two years if it is onshore, and after three years if it is offshore. The intention is to encourage the exploration of block areas that see no activities. Given Kenya's dependence on imported oil, the Model PSC also includes an obligation for the domestic supply of oil.

The Ministry of Energy and Petroleum issues the licences to explore or produce oil. Licences may be awarded through a competitive bidding process or through bilateral negotiations. To date, Kenya has not carried out any bidding rounds for granting licences. The National Fossil Fuels Advisory Committee (NAFFAC), a high-level inter-ministerial committee, negotiates with potential investors on behalf of the government.⁵⁴

Under the Petroleum Act, the Minister of Energy and Petroleum may grant non-exclusive exploration permits to carry out geological and geophysical surveys in respect of any open block. The Minister may grant more than one exploration permit for any block. Prior to granting a licence, the applicant may be required to provide evidence of financial and technical qualifications.

Under the Model PSC, key fiscal terms for undertaking oil production in Kenya consist of the following:

- Corporate tax is 37.5 percent for non-resident companies and 30 percent for resident companies. Deductible expenditures include: i) Capital expenditure covering acquisition of plants, machinery and industrial buildings ii) intangible drilling costs of non-productive wells also defined as costs which are incidental to and are also necessary in the preparation of wells for drilling and in actual drilling for the production of oil and gas; the costs may cover survey work, ground clearing, wages, fuel etc iii) interests on loans made for operations in Kenya iv) administration expenses, management and professional fees for all operations in Kenya v) losses brought forward from prior years; and vi) exploration costs.
- Capital expenditure is recoverable at a rate of 20 percent per annum. Costs unrecovered in any fiscal year can be carried forward.
- Total crude oil production not used in petroleum operations less cost oil equals profit oil; profit oil is split between the government and the contractor on a sliding scale, depending on daily production figures. The percentage split is a negotiable term.

⁵² See the Model PSC at: http://nationaloil.co.ke/pdf/sharing_contract.pdf

⁵³ The government has not put in the public domain the number of PSCs signed with companies as well their details.

⁵⁴ NAFFAC consists of Permanent Secretary of the Ministry of Energy and Petroleum who acts as the chairman of the Committee; Managing Director of NOCK who acts the Secretary of the Committee; Solicitor General of the State Law Office; Commissioner of Petroleum of the Ministry of Energy and Petroleum; Director General of the National Environment Management Authority; Commissioner General of the Kenya Revenue Authority; Commissioner of Mines and Geology; General Manager of the Petroleum Institute of East Africa; the Chairman of the Department of Geology of the University of Nairobi; Investment Secretary of the Ministry of Finance; Chairman of the Department of Public Law of the University of Nairobi; and Chairman of the Institute of Development Studies of the University of Nairobi.

- Taxes are payable on behalf of the contractor by the Government of Kenya from its profit oil share.
- No duties or levies are chargeable to contractors and sub-contractors on imported equipment.
- A signature bonus and surface fees; the signature bonus is a one-time payment to the government, although its payment may be spread over the life of the contract, for securing a licence. Surface fees are payable to the government on an annual basis per square kilometer of the relevant block during exploration and production.

With financial support from the World Bank, Kenya completed a legal, regulatory and fiscal review, carried out by the firms Hunton & Williams and Challenge Energy. As a result of this exercise, Kenya is now in the process of updating the Petroleum Act, given that it was enacted at a time when the country had no hydrocarbon discoveries. The update aims to address gaps in the Petroleum Act. The government wishes to introduce provisions for managing the interest of the private sector; assignments and transfer of PSC interests; and modalities for abandonment and decommissioning of petroleum operations. Other areas for update include contractual and fiscal terms for the production of natural gas; compensation for property; corporate social responsibility; reference to the Local Government Act; revenue sharing; capital gains tax; local content; and employment of Kenyan citizens.⁵⁵ The update may also incorporate legal formalisation of the NAFFAC.

The lead institutions responsible for managing the oil sector in Kenya are the Ministry of Energy and Petroleum and NOCK. The Ministry administers, upstream, midstream and downstream oil operations in Kenya. It also oversees the service delivery of state companies, such as NOCK, Kenya Pipeline Company Limited, and Kenya Petroleum Refineries Limited. Given the role assigned to the NLC by the Constitution in administering Kenya's natural resource, it is not clear how the responsibilities of the Ministry will evolve in the future.⁵⁶

In addition to its role of facilitating government participation in petroleum production, NOCK provides advisory services on oil to government policy-makers. NOCK also carries out commercial importation, distribution, and sales of petroleum products.⁵⁷ NOCK is emerging as an active player in upstream petroleum activities in Kenya. Key strategic and ongoing initiatives include developing human resources capacity for the sector; securing exploration and production rights and interests; creating upstream support services (e.g. onshore drilling service); and establishing research and technology collaborations with local and international institutions.⁵⁸

55 Project Information Document (Concept Stage) - Kenya Petroleum Technical Assistance Project (KEPTAP) - P145234 (English)," World Bank, October 24, 2013, at: <http://documents.worldbank.org/curated/en/2013/10/18437026/project-information-document-concept-stage-kenya-petroleum-technical-assistance-project-keptap-p145234>. The government has also developed Draft Energy Policy and Draft Energy Bill, which overlap with the proposed updates in areas such as revenue sharing and local content.

56 "Kenya Oil and Gas Review," Kaplan and Stratton, March 2013, at: http://www.kaplanstratton.com/fileadmin/user_upload/Kenya_Oil_and_Gas_Overview_-_K_S_April_2013.pdf

57 See National Oil Corporation of Kenya, at: <http://nationaloil.co.ke/aboutus/index.php?flag=aboutus&abt=1>

58 Interview with NOCK officials.

Annex II: Extractive Industry Good Governance Initiatives and Information Resources

The following lists selected examples of good practices and useful initiatives in the sector:

Extractive Industries Transparency Initiative

The Extractive Industries Transparency Initiative (EITI) is a global coalition of governments, companies and civil society working together to improve openness and accountable management of revenues from natural resources.

The EITI maintains the EITI Standard. Countries implement the EITI Standard to ensure full disclosure of taxes and other payments made by oil, gas and mining companies to governments. These payments are disclosed in an annual EITI Report (to see all EITI Reports, go to data.eiti.org). This report allows citizens to see for themselves how much their government is receiving from their country's natural resources.

The EITI Standard contains the set of requirements that countries need to meet in order to be recognised, first as an EITI Candidate and ultimately an EITI compliant country. The Standard is overseen by the international EITI Board, with members from governments, companies and civil society.

Natural Resource Charter

The Charter is a set of principles for governments and societies, developed by an independent group of the world's foremost experts in economically sustainable resource extraction, on how to best harness for development the opportunities created by extractive resources. It is not a blueprint for the policies and institutions countries must build, but instead provides the ingredients successful countries have used.

The Charter is directed primarily at policy makers and citizens in resource-rich countries. The charter can be read and downloaded from: <http://naturalresourcecharter.org/>

The Charter contains twelve precepts, namely;

- Precept 1: Maximising benefits for all citizens
- Precept 2: Promoting transparency and accountability
- Precept 3: Better fiscal regimes and contracting

- Precept 4: Better sector governance
- Precept 5: Environment, society and local benefits
- Precept 6: The role of national resource companies
- Precept 7: Investing the revenues
- Precept 8: Smoothing revenue volatility
- Precept 9: Better public spending
- Precept 10: Encouraging private investment
- Precept 11: The role of international governments
- Precept 12: The role of international companies

The EI Sourcebook

The Extractive Industries Source Book is a free online, interactive resource that is built upon a coherent and incisive narrative analysis of the sector as a whole, supplemented by hundreds of downloads and other web resources, including specially commissioned reports, summaries and briefs. The EI Source Book is produced through a partnership between the World Bank Group, a global consortium of universities led by the University of Dundee and professional associations. It can be accessed at: <http://www.eisourcebook.org/>

ICMM Case Studies and Toolkit

The International Council on Mining and Metals (ICMM) was established in 2001 to improve sustainable development performance in the mining and metals industry. Today, it brings together many of the world's leading mining and metals companies as well as national and regional mining associations and global commodity associations. The organisation produces a range of toolkits and publications that provide good practice guidance and promote sustainable development in mining. The ICMM's website is: <http://www.icmm.com/>

Publish What You Pay Resource Centre

Publish What You Pay (PWYP) is a global network of civil society organisations united in their call for oil, gas and mining revenues to form the basis for development and improve the lives of ordinary citizens in resource-rich countries. The organisation advocates for transparency in the extractive sector in order to enable citizens to hold governments and companies to account for the ways in which natural resources are managed. PWYP's network comprises over 600 member organisations across the world, including human rights, development, environmental and faith-based groups. The website for PWYP is: <http://www.publishwhatyoupay.org/>

Natural Resource Governance Institute (NRGI)

The Natural Resource Governance Institute conducts research geared towards providing policy advice on transparent management of revenues from natural resource extraction. The NRGI Resource Centre is a tool for knowledge-sharing and transparency advocacy, giving activists, civil society members, government officials, legislators, journalists and students access to hundreds of documents on the management of natural resource wealth. More information on the Natural Resource Governance Institute and can be accessed at: <http://www.resourcegovernance.org>⁵⁹

Information Centre for the Extractive Sector

The Information Centre for the Extractive Sector (ICES) is an independent information centre hosted by the African Development Bank. It aims to inform those affected by developments and activities in Kenya's extractive sector, connect actors in the sector, including Kenya's citizens and transform the dialogue and perceptions around the extractive sector.

Some of the categories covered by this website include information on CSO engagement with the extractive sector; donor programmes and studies, publications and reports from the private sector; governments' legislation and policies and best practices and lessons learnt from different countries.

The website is available at: <http://ices.or.ke/category/resources/cso-engagement-with-the-extractives-sector/>

⁵⁹ Natural Resource Governance Institute was formerly known as the "Revenue Watch Institute". This change took place during the June 2014 Natural Resource Charter Conference at Oxford, England.

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Africa Centre for Open Governance
P.O. Box 18157-00100, Nairobi, Kenya
Telephone: +254 20-4443707/0737463166
Email: admin@africog.org
Website: www.africog.org