

## **The Assessment of Policy and Institutional Arrangements of the Upstream Hydrocarbons Subsector in Kenya: Challenges and Opportunities.**

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**Abstract:** The Recent discovery of hydrocarbons reserves in Kenya has sparked heated debate on the economic, social and environmental implications in utilizing this resource. There is the fear of the so-called oil resource ‘curse’ or the paradox of plenty. The aim of this paper was to explore the county’s upstream oil and coal status and the emerging challenges and opportunities in the energy sector. The study largely relied on secondary data obtained from existing documentations on governance framework on the management of the resources locally and internationally also comparing approaches adopted by other countries and the pronounced consequences. This was supplemented by selected interviews with key stakeholders including government departments and agencies, community associations, civil society organizations and exploration companies. The findings indicate that the key issues in utilization of the resources is making the right strategic choices and synchronizing their implementation in a context that supports fiscal prudence and minimizes macroeconomic distortions. Establishing good resource governance frameworks, upholding of the principles of inter and intra-generational equity, and negotiating transparent contracts with sector companies, will sustainably utilize the county’s resources.

**Key words:** Hydrocarbons, Resource Curse, Governance, Institution, Contracts, Kenya.

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### **I. INTRODUCTION**

The staple theory of economic growth and development suggests that natural capital abundance would help a country to overcome her capital shortfalls and provide revenues for the government to provide public goods and services and therefore lift citizens out of the despair of poverty (Oyefusi, 2007). This is considered more convincing especially when considering the hydrocarbons (coal, oil and gas) as the natural capital, because energy is an indispensable input for economic growth and social development in any economy, where two-thirds of global energy requirements are met with oil and gas supplies. Likewise Fossil fuels (oil, natural gas, and coal) constitute 90 percent of commercial energy consumed globally (AfDB and AU, 2009). This demonstrates favorable and readily available market for the product, and is further illustrated by the worldwide economic ripple effects caused by price volatility and occasional spectacular spikes in the prices of these dominant global energy resources (Auty, 2001).

However, optimistic prediction of what hydrocarbons exploitation would do to an economy conflicts with the experience of most countries in Africa. Since the 1980s, studies have linked resource-abundance and a number of socio-economic problems and in some cases associated it with slow economic growth (Bruno and Sachs 1982; Sachs and Warner, 1995; Ron 2005). Of all natural capital, oil has been associated highest risk of civil conflict because of the large rents it deals and the shocks to which the government and the national economy are exposed to (Collier and Hoeffler, 2005; Fearon, 2005; Collier and Goderis, 2007). History has shown that for an exporting economy, in most cases, oil boom leaves it in a worse state: because economic ills that it is anticipated to reduce i.e. poor housing, infrastructure, environmental pollution, and lack of access to clean water, health care, and education are really resolved (Bell and Memba, 2010). At the same time the environmental impacts of oil production and usage places significant pressure on all nations regardless of whether they are net oil exporters or net oil importers (UNEP and IISD, 2004).

At the same time, the strategic value of oil gives oil-exporting countries power and influence; and this may be demonstrated by most oil-producing states in Africa and Middle East who enjoy close diplomatic ties with the US and other OECD countries despite in some cases, their poor human rights records. While countries

with equally bad human rights records but little or no oil in the same region typically receive harsher treatment, indicating that without hydrocarbons, these countries and their leaders would have less international influence, and could find it harder to reach their foreign policy goals (WARW, 2011). This diplomatic influence makes oil-rich governments less susceptible to international pressure on other issues, such as poor; internal socio economic governance and human rights abuses as well as increased environmental degradation (Frieden and Rogowski, 1996). Thus situations, although oil and coal resources are a principal source of public revenues and national wealth, issues of transparency, accountability, and income distribution have led to years of bloodshed and destruction (Duruigbo, 2004; Bell and Memba 2010) or degenerate into the paradox of plenty, the Dutch disease (Auty, 2004; WARW, 2011).

Kenya imports all petroleum requirements, accounting for about 25% of the national import bill (GOK, 2012c). Just as elsewhere petroleum fuels are the most important source of commercial energy in Kenya, and are mainly used in the transport, electricity generation, commercial and industrial sectors. In 2011 the consumption of petroleum fuels in Kenya was 3.9 million Tons of Oil Equivalent (TOE). This is equivalent to a per capita consumption of 94.4 kilograms, which is considered as low compared to the standards of developing economies, and is attributable to low industrialization and economic growth (GOK; Economic Survey 2012a). The survey also indicates that retail pump outlets and road transport accounted for approximately 63.4% of petroleum consumption, industrial and commercial sectors accounted for 11.4% while electricity generation accounted for 8%. Coal is currently exclusively used in the cement industrial sector in their heating process, the level of consumption between 2006 and 2011 consumption of coal averaged 130,000 metric tons per annum (GOK, 2012c). But the county intends to turn a coal driven electricity power plant, almost doubling the current installed electricity capacity (2,300 MW). The aimed is to providing a base-load capacity at low tariff. Therefore ensure a high electricity availability and reliability. This is because coal power plant has the flexibility to reduce or increase generations compared to other power sources that are inflexible making consumers pay additional costs for unused power. In Kenya currently, a rise in oil prices leads to, deterioration in the terms of trade, inflation and subsequently to a fall in the purchasing power of firms and households.

But recent reports from coal and oil explorations in Kenya indicate that there are considerable oil and coal deposits in the country (GOK, 2012c). This should be a welcomed scenario, as it is anticipated to help reduce energy deficits and accelerate growth in the country if utilized strategically.

### **1.1 Statement of the problem**

Kenya like most developing countries continues to face a range of development challenges. High amongst them are: slow economic growth, environmental degradation, ethnic, political and economic divides. Therefore, with the discovery of hydrocarbons in the country, Kenya's future development challenge will be that of avoiding what is generally considered as a "resource curse" or the paradox of plenty. For this, mechanisms must be put in place by the government to formulate institutional and policy arrangements that will enhance sustainability in terms of; prosocial development, environmental and secure economic stability.

The challenge for Kenya is that if indeed there are substantial coal and oil reserves, how can they avoid the curse and make the resource work for the benefit of the country in the long term? How can they turn this potential "curse" as already demonstrated in other developing economies into a blessing? This is because developing countries (especially in Africa) with vast deposits of solid minerals and oil/gas are generally characterized by majority of their citizens languishing in poverty and most of the countries being unstable. Oil is one of the most political of the natural resources in Africa. Worse more the discovery is happening when Kenya as a country is intensely a political nation (characterized with regional, ethnic and gender discriminations as well as her top leadership being accused by The International Criminal Court (ICC), for crimes against humanity; (following the post election violence of 2007/2008). These depict a nation fighting itself. The country is also experimenting on a devolved governance system (GOK, 2010). Kenya is also considered by most global partners as a strategic partner in the region and globally yet, today oil lies at the centre of intense commercial rivalry and competition between the old imperial powers of Europe and America and the emerging economic giants BRICS (Brazil, Russia India, China and South Africa). The key issue here is how the government will engage the production partners, administer resource wealth and how they will use hydrocarbon resource revenues.'

### **1.2 Objectives of the study**

The broad objective of this paper is to discuss major issues that need to be considered in order to minimize or eradicate the negative social, economic and environmental impacts of oil and coal exploitation in Kenya.

### **Specific Objectives**

The specific objectives include:

1. Assess the county's hydrocarbon (oil and coal) status and its major challenges and opportunities in the energy subsector in Kenya.
2. Discuss the potential benefits and production contractual approaches adopted by Kenya in the upstream hydrocarbon industry.
3. Determine the institutional capacity at national and local level participation in oil and coal revenue management.
4. Outline the roles of the development partners and global policy initiatives in the development of the hydrocarbon industry in Kenya.

## **II. APPROACH AND METHODOLOGY**

The study largely relied on qualitative data. The bulk of the work involved literature review: mainly public information from institutions such as the World Bank, African Development bank, The government of Kenya as well as content survey of internet and print publications. These were supplemented by selected field work. Interviews were done with key stakeholders that included: officials from the key government departments and agencies, resource users associations, community associations and members of CBOS, NGOs. The two local communities associations were understudied to assess the impact of the existing policy, legislation and institutional framework on the management of their oil and coal resources. The data was then reduced, organized and interpreted on the basis of themes generated from the data analysis and in line with the objectives of the study.

## **III. RESULTS AND DISCUSSIONS**

### **3.1 Hydrocarbons (oil and coal) Exploration Status in Kenya**

Oil exploration activities in Kenya have generally been led by foreign oil companies and exploration in Kenya is considered to have begun in the 1950s, with the drilling of the first well occurring in the 1960s. But until recently although some of these wells encountered oil and gas traces, none of them had any commercial deposits (GOK, 2004). These works were undertaken under a royalty based licensing system provided for under the *Mining Act, Cap 306*.

In 1982 the Petroleum Exploration and Production Act, Cap 308 was enacted to govern petroleum exploration and improve incentives to companies involved in exploration in Kenya. Significantly in the 1990s there were low exploration activities, this was mainly attributed to depressed international crude oil prices which made it unattractive for prospecting companies to venture into areas perceived to be marginal (GOK, 2004). According to this document, most of the exploration activities undertaken during this period largely consisted of collection and analysis of primary data by National Oil Corporation of Kenya (NOCK), a government institution.

The recent exploration developments in Kenya is that a UK oil exploration firm, Tullow Oil, has discovered fresh oil deposits of commercial quantities in the remote arid region of Turkana, in the northern part of Kenya (Njagih and Muchira, 2012). This has heightened Kenya's prospects as the East African region's oil giant. "Tullow Oil plc announces that the Ngamia-1 exploration well onshore Kenya in Block 10B when drilled to an intermediate depth of 1,515 metres and the total net oil pay encountered so far has increased to an excess of 100 metres across multiple reservoir zones,". Moveable oil with an API greater than 30 degrees has been recovered to surface (Njagih and Muchira, 2012). While coal deposits have been discovered in Mui basin in Kitui County. The government is likely to sign a concession with a Chinese firm to mine an estimated 400 million metric tons of coal deposited at the basin (Muchira, 2012)). Therefore Kenya may be considered to have proven reserves. Although reserve estimate in hydrocarbon exploration is considered as dynamic and can change depending on: the technology being employed, economic conditions (i.e. the price of selling oil versus the costs of extracting it), location, and associated environmental issues (Hyne, 1995; AfDB and AU, 2009; AfDB, 2007).

However, according to experiences elsewhere estimation data on oil and gas resources from geological resources may also be inaccurate for a number of reasons, including: weak government capacity to monitor oil companies (which may not wish to have an accurate data disclosure); geopolitical interests of governments (who may not want a full disclosure either); or lack of geological survey data (AfDB, 2007). Even though, the measurements are presumably physical and therefore easily quantifiable.

The discovery of these commodities offers a rare opportunity for Kenya to transform her economy and society. However, various countries have had such opportunities but it was largely, un optimized because governments took inappropriate decisions (partly owing to poor knowledge and skills) and misaligned incentives facing decision-makers (Al-Attar and Alomair, 2005). Therefore the exploration and exploitation of these resources are yet to benefit the larger populations, for example: Nigeria has been exploiting oil resources

for the last 50 years and is now the world's fourth largest oil exporter. Yet, its human and physical capital development is assessed to be 400 percent lower than it would have been if the oil revenues had flown into public funds, and if such funds had been utilized in the public interest to generate economic opportunities for all (ATAF, 2012). Issues of concern are listed as: technical limitations, inefficient contract negotiations, inadequate auctioning of extraction rights, inefficient taxation, poor public expenditure prioritization and (lack of) transparency in the use of revenues (AfDB and AU, 2009; Al-Attar and Alomair 2005). But it has, however, been demonstrated elsewhere that "natural resource curse" can be avoided with the right institutions and policies. Therefore a reason for optimism that Kenya has learned lessons from other African countries which have been in similar situations and will pursue strategies and policies that will allow her to fully reap the benefits of their hydrocarbon resources wealth.

The discovered hydrocarbons are located in Arid and Semiarid lands (ASALs) parts of Kenya, marginalized and underdeveloped areas (Turkan and Kitui). These ASAL areas ("new development frontiers") are significantly under developed compared to other parts of the county and have some of the lowest human development indexes in the country (GOK, 2012a), among the drivers of their underdevelopment include: unfavorable climatic conditions, the urban rural divide, National Policies focusing on "high productivity" agricultural areas, as well as regional and ethnic discrimination (GOK, 1984; ODI, 1985). Therefore the discoveries are likely to generate hostility between the local populations on one hand and the government, communities from other parts of the country considered as advantaged, including potential local and foreign investors on the other hand.

Considering the relevant national policies, development plans, strategies and legislations (i.e. Kenya national energy policy, The Energy Act, The Petroleum (Exploration and Production) Regulations, 1984, Vision 2030 etc.) The development of the Petroleum upstream sectors may not be considered as well coordinated, planned and institutionalized for sustainable development. Therefore the National government needs to go through the logical process of formulating policies, strategies and adoption of laws that fully address the upstream oil and coal sub sectors.

### **3.2 The energy sector in Kenya and the discovery of Hydrocarbons**

Kenya faces tremendous challenges in terms of improving the welfare of its citizens. The country has some of the world's highest inequality, and unemployment rate (averaging over 40 %), and the price of energy is a major concern to the industrial investors, who considered it as the highest in the region (Mokaya, 2012; KEPSA, 2013).

Energy is central to addressing many of today's global development challenges, including poverty, inequality, climate change, food security, health and education. The Kenya Vision 2030 correctly identifies energy as a key infrastructure and enabler of social economic progression. The government has put emphasis on generation of additional electricity, especially from renewable resources. Today, only about 30% of the country's population has access to electricity as demand has outgrown supply. The total installed generation capacity is estimated to be about 1,600 megawatts and more that 49% is based on Hydro resources which are often challenged during dry seasons. A significant over 35% is generated from thermal sources (GOK, 2011). Peak electricity demand is projected to grow to 2,511MW by 2015 and 15,026MW by 2030. To meet this demand, installed generation capacity is projected to increase from 1,645MW in 2012 to about 19,000MW by 2030 (GOK, 2012c).

Therefore this shows that hydrocarbons discoveries in the country, if utilized, has a potential of drastically reducing the cost of energy and enhance access to energy service delivery to the population. However, the pursuit of Fossil fuel (coal and oil) based energy generation may be considered anti ethical to environmental consequences and therefore against the global goals of a Green Growth (GG) agenda, which is focused on development pathways resulting into low carbon economies (UNEP, 2011). An example is South Africa which is endowed with coal but the country's "dirtiness" is almost entirely due to its dependence on coal-based energy, which accounts for 80 % of total emissions (RSA 2011). This undermines its position in global forums and faces the threat of retaliatory trade policies from countries that do reduce their emissions (Arndt *et al.* 2011). Yet the cost of energy has significant impact on economic activities and energy prices are a significant determinant of competitiveness of locally manufactured goods relative to imports. Presently high energy prices are impacting negatively on domestic wealth creation, balance of payments and employment creation since consumers opt for cheaper imports (GOK, 2012c).

At the global arena the energy sector crises are multiple: fossil fuel depletion, greenhouse gas emission, energy insecurity, price increase, geopolitical tensions, as well as the energy generation are strongly related with climate change issue (Cheung and Chanard, 2010). Therefore, global forums have adopted a common strategy for addressing energy issues and contributing to climate change policy.

High energy (electricity) prices in the country is mainly attributed to thermal generation of electricity using fossil fuels (KEPSA, 2013) and unreliable seasonal peak energy production from Hydropower sources.

This may change if the country decides to pursue and use available fossil fuels (coal and oil) to generate electricity. This will obviously see the country undertake an environmentally suboptimal strategy although addressing critical development needs. But it may be argued that Kenya as a global partner should commit to energy sector development strategies which will result into energy saving actions and increase renewable energies development. Indeed, the proposed national energy policy for Kenya (GOK, 2012c) targets that the country should generate at least 70% of electricity from renewable resources and the government has generally adopted a climate change resolution in international forums. Highlighting her intention to climate change adaptation and mitigation (including mitigating GHGs emissions) adopting a low carbon growth path (National climate change strategy etc). Adopting a green growth approach would prove to be economically costly and not allowing the country to use her comparative advantage and may generate substantial domestic resistance. But renewable resources such as the solar, wind, waves, geothermal, biomass and hydropower are locally sited in Kenya (GOK, 2011) and therefore it is upon the national government to engage the right policies and strategies and ensure that this potential is appropriately harnessed through the promotion of green power.

### **3.3 The Potential benefits from Oil and Coal Resources in Kenya**

#### **3.3.1 Initial contractual Agreements**

One of the key concerns is that the governments of African oil and gas producing countries receive an inadequate share of the large rents from production (Daniel, 2001; Oyefusi, 2007). How does this come about? And can Kenya avoid the trap? Resource utilization and management are the most contentious issues in this region because they pose fundamental issues such as; the problem of governance, individual and communal inequalities (especially in terms of access and patterns of control of resources), inter-group conflicts and violence and physical environmental problems (Daniel, 2001). But it is argued that the Key to ensuring transparency and accountability is an appropriate legal framework including the initial contracts of engagement between the government and the developers.

The Constitution of Kenya (CoK) 2010, section 62(f) defines all minerals and mineral oils as public resources. This is a clear indication that minerals in Kenya are held in trust by the national government on behalf of the people. Under section 69(1)(a) of the constitution, the national government is obliged to ensure sustainable exploitation, utilization, management and conservation of the environment and natural resources, as well as equitable sharing of the accruing benefits. Further section 71(1) (a) requires ratification by national parliament of some of natural resources agreements.

However, it is important to note that oil exploration has been mainly speculative and that Kenya, for a long time was perceived as only having marginal potential for hydrocarbons. Therefore, the country had only attracted a limited number of oil exploration companies based on the flexibility of the production-sharing model contract embedded in the Petroleum Exploration Act, where the sharing of cost oil, profit oil, surface fee, training levy including government participation is negotiable. It is important to note that the legal framework under which oil companies operate together with geological, geographical and political factors make a country or region more or less attractive for investors (ADB and AU, 2007).

This production sharing contract model to some extent, may favour the exploration companies more than governments and local businesses, because the terms are mostly structured to bring in investors, sometimes at all costs. These contracts contain stabilization clauses to protect the investing companies in the event of changes in local laws and other conditions. These arrangements result into contracts and regimes that are not designed to extract maximum rents but policies that are designed primarily to promote and attract investments and may have little to do with protecting local and national interests in the eventuality that the hydrocarbon is discovered.

Therefore some countries have found themselves in a situation where they have moved from one hundred percent ownership and control to being just rent collectors and most of them currently desire to review their contracts to increase government take and to take better control of their natural resources for local and national development.

Although rent (the value of mineral resources minus all the necessary production costs from oil exploitation) is considered as significantly large the sharing of this substantial rent between the governments of oil-producing and oil-consuming countries and oil companies has historically been contentious. Where the bulk of the rents created in these economies are channeled by bureaucrats, the majority of whom are members of the politically dominant groups, such behavior produces undesirable results for the economy (WARW, 2011). According to The World Bank's Oil, Gas and Mining Policy Division; there are three major types of upstream arrangements: joint ventures (JV), production sharing arrangements (PSA), and service contracts (SC). More than one type of agreement has been utilized in a number of oil producing countries. This is based on the diversity in costs (exploration and production) and reserves (size) in various oil fields in the countries (offshore and onshore) as well as the prevailing regime (policy) at the time (AfDB and AU, 2009).

Table: Risk and reward of the main contract types

Contract	Foreign Contractor	Government
Concession	All risk/ all reward	Reward is a function of production & price
Production Sharing Arrangements (PSA)	Exploration risk/share in reward	Share in Reward
Joint Venture (JV)	Share of risk and Reward	Share of risk and Reward
Service Contracts (SC)	No Risk	All Risk

*Adopted from AfDB and AU, 2009)*

Kenya’s contractual agreement with the developer is not yet in the public domain but it is of significance on how the country is likely to benefit from these discoveries. Probably the production sharing agreements (PSAs) are yet to be finalized. But according to the sessional paper no 4 on energy (2004) the government undertook to carry out the minimum needed exploration works in areas designated for licensing by the National oil Corporation (NOCK). This was expected to minimize financial risks and therefore help to attract more oil prospecting companies and hopefully to inform balanced contractual agreements.

Kenya’s post-independence history will be very important in determining the effects of the resource curse, although in East and central Africa the country’s economy is already one of the biggest. But there are concerns of social injustice and biased/ uneven development perpetuated by the previous government regime. There has been an attempt to correct these injustices and the CoK 2010 is perceived to have solutions to the problem through the proposed devolved government system. Areas claimed to be housing the oil and coal resources (Northern Kenya) are considered as significantly marginalized compared to other parts of the country; in terms of their development levels (education and infrastructural development) and their populations’ participation in governance and access to opportunities. Most importantly, the oil discovery is onshore (as compared to off shore for some countries) meaning that the oil industry will definitely influence land use and introduce land use changes and will have a lot of ties to the rest of the economy (agriculture etc). Land ownership and allocation is one of the major socioeconomically thorny issues in the country. But it is anticipated that the hydrocarbon utilization on land may also bear a positive perspective as it will require that certain minimum infrastructure development is put in place (roads etc) and this may have an immediate positive impact in the area, therefore increasing cooperation among the local community members.

Factors such as i) Unfavorable institutional arrangement and legal framework for the production sharing in the sector; (ii) Lower returns to host communities in the initial years, as they repay the expensive exploration cost, largely determined by the exploration companies; iii) and The lack of inclusion and benefit to the local community population are considered as recipes to the resource curse (Bell and Memba 2010).

Kenya’s energy legislation is currently in the works, the Petroleum (Exploration and Production) Act Cap 308 is also under review. According to the ministry of energy official the PSC Model to be adopted will ensure that the government, local authorities and communities get the most i.e., local communities living in the areas, affected by the exploitation of the natural resources, should be effectively involved. This is necessary to ensure that the hydrocarbon resources benefit the host country, community and the oil company. The government has engaged the international monetary Fund (IMF) to review existing petroleum PSCs and propose a model hydrocarbon development contract (Karambu, 2013).

The draft proposal model of production sharing suggests using one production sharing framework for both oil and coal dealings. The proposal is that the current model of calculating government revenue based on the daily rate of production (DROP) in production sharing agreements (PSCs) be replaced by the ratio (R-factor) of the firm’s cumulative hydrocarbons revenues to total costs.

The move aims to ensure government revenue increases to correspond to hydrocarbons output of licensed firms with production costs and total revenues realized being used to compute the state’s share after a discovery. The R-factor balances taxation with project profitability and ensures the state receives a significant share of money. Ministry of Energy officials indicated that the intended shift to R-factor is meant to ensure government revenue rises progressively with an increase of hydrocarbons production while Kenya remains competitive and attracts investment.

Kenya has had a long exploration history with no commercial discoveries, which increases the risk for investors due to greater uncertainty but with a progressive R-factor it is said that; if a discovery is not made, the investor’s loss is limited to costs incurred during the exploration phase. The R-factor has been successfully adopted in Mozambique and India (Kathuure, 2013).

But there is also a need to manage the perception of the communities and the modalities of the benefits must not lead to damaging the other local productive or tradable sectors of the economy, such as the agriculture, livestock production, tourism, fishing, entrepreneurship etc. making them less attractive or uncompetitive.

### 3.3.2 Socio economic implications

Hydrocarbons by their very nature have a centralizing effect on economies and dependence on a few or single export concentrates wealth in the hands of the few, and leaves majority too vulnerable to downturns (Duruigbo, 2005). However, at present, Kenya's economy has multiple streams of revenue generation. The agriculture sector currently contributes about 24% of the country's Gross Domestic Product (GDP). It accounts for some 30% of the country's export earnings and 12% of its tax revenues (GOK, 2012b).

Experience elsewhere shows that large windfall revenues may lead to poor decision-making by governments (Ploeg, 2007; Auty, 2001; Auty, 2004; Stevens, 2003): Resource booms raise expectations and increase appetite for spending. A boom mentality not only affects the way governments behave it also shapes how people respond i.e. raising expectations among the population. This if not well managed often leads to quick, inappropriate decisions by government, which weakens prudence and normal procedures of "due diligence." For example the governments may decide on capital spending without due consideration to recurrent spending implications, fosters excessive and imprudent investment. This means that spending quickly surpasses revenues and various interest groups continue to demand even larger shares of national income. Presently, this is may be considered as common phenomenon in Kenya even without a wind fall considering the public expenditure scenarios where over 60% of the national budget is on recurrent expenditure (GOK, 2013).

A windfall also leads to mismanagement and misallocation of resources and, in the most severe cases, corruption (CBCF, 2005). The key issue is that natural resource revenues tend to replace more stable and sustainable revenue streams, exacerbating problems of transparency and accountability. With sizeable resource revenues, the reliance on non-resource taxes and other government incomes decreases. This tends to free natural resource-exporting governments from the types of citizen demands for fiscal transparency and accountability that arise when people pay taxes directly to the government. Thus, natural resource export earnings actually sever important links between the people and their governments, links related to popular interests and control mechanisms. The larger the public purse, the less noticeable the leakage to interest groups (Stevens, 2003).

Hydrocarbons (oil) must not be allowed to become the dominant source of national revenue and foreign exchange. Since Kenya is a subsistence economy, traditional livelihood and revenue generation sectors such as agriculture and tourism should not be neglected but expanded and at the same time cushioned from the pollution associated with mining and hydrocarbon exploitation.

### **3.4 The Institutional Capacity at National and Local level Participation in Oil and Coal Revenue Management.**

There is a generally observation that; the resource abundant countries (e.g. Nigeria, Sierra Leone, Angola, and Venezuela) seems to lag behind countries with fewer resources (e.g. the Asian tigers: Hong Kong, Korea, and Singapore) in economic growth and development. These diverging experiences have been associated with the quality of a country's institutions (WARW, 2011). That is how a country's institutional arrangement shapes the distribution of rents or the allocation of entrepreneurship between productive and rent-seeking activities (grabbing) in the country. Therefore resource 'curse' phenomenon only occurs in countries with weak or ineffectual institutions (Humphreys et al., 2007).

Therefore the discovery of oil will put Kenya's institutional arrangements to test, as observed in other countries where hydrocarbon production has resulted into deterioration of the quality of institutions in those countries (WARW, 2011). Thus, it is suggested that oil exploration should be matched with policies aimed at improving or sustaining the quality of existing institutions, including openness to international trade, labour, credit, and business regulations as well as strategic cautioning of the current key production sectors in the economy e.g. agriculture, tourism and service sectors.

Proposals in the draft energy policy following the discovery of petroleum and coal deposits, suggested that the Government shall: (a) Adopt and implement the Extractive Industries Transparency Initiative (EITI) Treaty as a demonstration of its commitment to good governance, increasing scrutiny over revenue collection from these resources, and improving the country's investment climate; (b) Reconstitute the National Fossil Fuels Advisory Committee (NAFFAC) and anchor it in law. (c) Develop mechanisms for sharing of benefits between the National and County Governments as well the local communities in accordance with Article 69 of the Constitution. The Petroleum Exploration and Production Act Cap 308; provides the legal framework and regulates the negotiations and conclusion of Production Sharing Contracts with potential investors.

The present areas where the hydrocarbons are to be exploited are in the inland, Turkana County, which is an ASAL area prone to famine, cattle rustling and insecurity. It is one of the most marginalized and underdeveloped areas in Kenya with a poverty index of 98% (GOK, 1984). The challenges that will be faced by the host communities as a result of oil exploration include; the influx of individuals buying land, the degree of involving the local governance institutions by the national government in decision-making related to oil exploration, Land use changes including: the potential destruction of livestock grassing zones, aquatic and terrestrial habitat destruction, and the displacement of households. During the production phase aspects of water

pollution from oil spills (in the limited surface water sources) may result in the long-term degradation of the environment as is the case in the Niger Delta region (Duruigbo, 2005), where oil has done significant damage to both the local community and the ecosystem. Socioeconomic changes such as: conflict over the distribution of oil benefits, sociocultural and lifestyle changes, and the risk of social diseases such as STD/HIV/AIDS are also likely to emerge as a result of oil exploration and extraction.

Thus there is need to put measures in place to mitigate these environmental and socioeconomic challenges including; developing within the host communities a basic knowledge of the risks and benefits of the hydrocarbon industry guided by a detailed social impact assessments (SIAs) as well as Environmental Impact Assessment (EIA) as part of project preparation and the government should enforce the monitoring plans inclusive of a budget towards mitigating all the negative impacts.

Experiences elsewhere indicate that contrary to popular expectation, minerals rarely bring any new jobs to the locals to replace old forms of communal subsistence. Instead, the common observation is that the multinational corporations that get the mining rights prefer to import laborers from rival communities or distant lands rather than create jobs for communities most immediately affected by extraction operations. A situation if not appropriately addressed, the cruel reality is environmental pollution, communal conflicts and poverty (Adewale, 1992). There is already concern that among the hired workforce during exploration only 40 out of 500 people were locals. This is an indication of either insensitivity by the authorities or lack of capacity from the locals. Thus there is need to embarking on an analysis of human resource needs for the production process followed by capacity building among the locals and adoption of favourable laws and guidelines on employment.

The recent changes in the constitution (CoK, 2010) has brought in devolution, this in the long run is likely to strengthen the local governance institutions envisaging community participation, But for the moment there is obviously a “young” governance structure at the local level and this may be an impediment to the meaningful engagement of the locals during the initial planning and development of the resource. The national and county government should actively safeguard and expand existing democratic space and civic liberties. Considering that citizen participation in decision-making is key and should be actively promoted. In this regard, operationalization and strengthening of the devolved county governments is crucial, as emerging issues will be discussed and determined in a transparent manner to avoid discontentment and disputes.

During KIIs a number of concerns were raised. These included the need for the local community to moderate their expectations regarding oil revenues since these would be shared with the rest of the country and effort must be made for the host community to understand Kenya’s laws, Across the region, citizens have gone to court to block extraction of mineral resources, where benefits to the local community are not clearly spelt out. For example, residents of the coal-rich Mui Basin in Kitui County sought to block the mining company from mining in the area, claiming that the deal was an infringement of their constitutional rights. It was also noted that the community needed to be cautious of politicians who heightened expectations, as this could lay grounds for conflict. Although the constitution is considered as a good guideline for sharing hydrocarbon revenues, the devolved system of government would benefit the local community only if the community held its county leaders accountable. But clear and properly considered policies are the solution to concerns on fairness and equitability.

The challenges regarding the implementation of good policies, requires education and sensitization of the communities especially through the active participation of the civil society organizations and citizens who may provide checks and balances to ensure that the policies are effectively implemented. The production process should take care of the immediate social and environmental concerns of the local population for example land, vegetation, livestock and water. If affected by the exploration, then the affected population should be compensated and that this needs to be included in agreements with local communities and in a policy framework.

Kenya intends to use hydrocarbon revenue to support the national and county budgets as well as ensure communities residing in hydrocarbons production areas get a share of the proceeds. Industry analysts expect new policy on revenue sharing to come into effect earliest before the end of 2013 after the reviewed Petroleum Exploration and Production Act is approved by parliament in line with the constitution. But the geological minerals and mining bill 2012 (which excludes oil but include coal) has suggested a sharing arrangement without specifying the benefits that will be utilized especially by National and County government. It is also not clear if a fossil fuel sovereign fund should be created, which is outstanding in other royalty sharing models for sustainable hydrocarbon development.

**The table 2:** shows recommendations on sharing of royalties as presented in the third schedule of the draft geological minerals and mining bill 2012; which includes coal resources but not petroleum.

Sharing of Schedule	Section 158
National Government	75%
County Government	15%
Community	10%

The bill (geological minerals and mining bill 2012) further suggests that where more than one county or community is involved in sharing of royalties, the royalties will be shared accordingly without defining a community. At the same time the sharing provision further outlines that every community benefiting must annually submit a proposed programme with budget and the community will submit a report on usage and disbursement of royalties. This does not take into consideration the capacity in terms of developing and undertaking the programme as well as the capacity to utilize the funding in good time.

### ***3.5 The Roles of the Development Partners and Policy Initiatives in the Development of the Hydrocarbon Industry***

Extractive industry revenue tends to be uncertain, volatile, and exhaustible; characteristics that all pose enormous challenges to policymakers (Ahmad and Mottu, 2003). Kenya's mining industry has largely thrived on secret contracts between government officials and mining companies, sometimes attracting the wrath of communities and civil society groups over allegations of corruption and environmental negligence (Mghanga, 2011). It is worth noting that the resource 'curse' is in part a spin-off of a skewed international trade and legal system that compromise developing countries' sovereignty over their natural resources (Oulu, 2013). Western powers (and lately China) and their multinational corporations tend to exert undue influence over the terms of extraction, inhibiting democratic dispensations from developing while exploiting the environmental, health and labor laws far more lax than those in their own countries (WB, 2006). Utmost care must therefore be taken when signing exploration, exploitation and revenue sharing agreements. But Kenya must similarly look inwards. The developed countries and their petrochemical corporations succeed largely because they have in-country collaborators in the form of elites and corrupt leaders (Ross, 2012).

According to African Tax Administration Forum (ATAF) report (2012) over \$1 trillion (KSh. 84 trillion) is lost annually through tax corruption in Africa, as deals between companies and governments in the sector (including tax incentives given through deal-making outside the policy framework) continue depriving the citizens of the benefits associated with discovery of natural resources across the continent, and that African countries receive less revenue from natural resources than many other countries in the world, (ATAF, 2012).

The forum suggests that there is need for the governments to renegotiate these deals within three years of oil production because the companies tend to be largely favoured during the initial stages. Contracts are often subject to strong confidentiality clauses by multinationals, governments, investors and banks involved. While the revenue losses are due to lack of tax experts, especially in the sector coupled with ill intentions of those who want to control a country's natural resources.

Therefore it is prudent for International Monetary Fund (IMF) and World Bank to provide technical assistance to countries such as Kenya to build capacity and in negotiating contracts for taxing extractive industries as well as advice governments on policy, legal/regulatory, and fiscal frameworks that promote transparent and equitable growth of the extractives sector through foreign and domestic private sector investment and Public Private Partnership (PPP) initiatives. These development agencies should also assist governments to ensure that extractive industry operations are developed in an environmentally and socially sustainable manner.

Several international policy initiatives, mechanisms, and standards have also been launched to address these dilemmas and improve governance, and reduce the observed environmental and socioeconomic impacts of extractive industry activities. These include: The Extractive Industries Transparency Initiative (EITI), The international Publish What You Pay (PWYP) campaign, The International Council on Mining and Metals (ICMM), The Kimberley Process Certification Scheme (KPCS), The Equator Principles (social and environmental standards), The African Peer Review Mechanism (APRM) (AfDB, 2007) among others. This institutions supports production and dissemination of good practices for sound extractive industry sector governance and management. Therefore it is upon the country which is aiming at prudent management of her hydrocarbon resources to embrace and join other global civilized societies and benefit from such schemes.

The World Bank also has established Extractive Industries Technical Advisory Facility (EITAF) an advisory services on a demand-driven basis, for capacity building for extractive industry resource policy frameworks and transactions. The objective is to assist resource-rich countries to correctly structure extractive industry transactions and related sector policies from the outset, thus reducing the risk of costly or politically difficult remediation at a later stage ([www.worldbank.org/ogmc](http://www.worldbank.org/ogmc)).

The global Extractive Industries Transparency Initiative (EITI), launched in 2003, promotes and supports improved governance and transparency in resource-rich countries through the full publication and verification of company payments and government revenues from oil, gas, and mining. As a voluntary association of stakeholders with shared goals, the global EITI structure comprises resource-rich developing countries, donors, international and national resource companies, and civil society. In the draft National Energy Policy, the government has committed itself to adopt the Extractive Industries Transparency Initiative (EITI) treaty a global standard that promotes revenue transparency.

The World Bank's Oil, Gas, and mining policy division manage a Multi-Donor Trust Fund (MDTF) that provides countries with grant resources to implement the EITI principles of revenue transparency. Countries work closely with Bank country teams and other development partners. As of July 2009, 30 countries are implementing EITI, 20 of which are in Africa. Eight African countries have produced EITI reports. These countries are now approaching validation—the test of whether they have met all of the indicators in the EITI standard. The World Bank MDTF grants help support technical assistance and global knowledge sharing activities in EITI implementing countries (Jourdan, 2006; [www.eitransparency.org](http://www.eitransparency.org)).

In summary, and looking ahead, the EITI has recorded some significant achievements, although it is voluntary in nature. It is increasingly being recognized as a partial solution to the problem of corruption in energy-rich developing countries. However, the EITI faces a number of challenges that need to be addressed (EITI, 2007; AfDB, 2007b): for example not all countries that have adhered to the EITI have started implementing it in its full extent. Many countries thus only show rhetorical commitment and only actually implement the initiative to a limited extent.

#### IV. CONCLUSION

The government of Kenya should avoid excessive dependence on hydrocarbon revenues to support the recurrent budgets, an institutionally unstable revenue allocation system. But should endeavor to develop responsive political and institutional arrangements, as well as engage her citizens who should demand for transparency and accountability from the government, and avoid a marriage of interest between the national or county government and oil companies which often encourage the government to use repressive measures against host communities in cases of disputes. Otherwise the government should ensure the development of strong institutional arrangements manifesting in well thought out policies and laws, institutionalize and enforced.

Kenya needs to immunize herself against the “Natural resource curse” using appropriate economic and environmental policies, institutional reforms and substantial political will for the country to address the resource curse and break the conflict trap associated with hydrocarbon -dependence, as demonstrated in several countries (Australia, Botswana Canada, and Norway); Therefore there are there are reason for cautious optimism as illustrated by several case studies where hard lessons may learned from. . Therefore Kenya needs a detailed programme for the effective management and sustainable development of her new found hydrocarbon resources. The challenge is mainly in implementations which need to be carefully executed. If these measures fail (as they sometimes do), the country needs to remind itself that leaving the oil in the soil is a viable option. It is sometimes optimal when one does not exploit a country's natural resources.

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