DRAFT
STUDY ON PETROLEUM INDUSTRY IN KENYA

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1.0 Introduction

Given that petroleum products have no close substitutes, their prices have a major feedback effect in the Kenyan economy. They permeate every aspect of production and distribution in the economy. Therefore, rising prices of petroleum product would have significant implications on inflation, employment, poverty reduction and general long term growth prospects of an economy. Since 2005, petroleum pump prices have been surging at relatively higher rate than crude oil, implying a cartel-like pricing approach by the major oil companies. In a study conducted from July 2003 and May 2004, the Monopolies Prices Commission investigated pricing of some petroleum products and found no explicit coordination among oil companies (UNCTD, 2005). However, based on anecdotal evidence, the inter-ministerial task force found cartel-like behaviour by the major oil companies.

The purpose of this study is to examine petroleum industry to determine empirically whether the major oil companies have a market power. Specifically, the analytical framework will entail determination of price elasticity of the residual demand of petroleum products. The structure of paper is as follows: Section 2 provides the background information including the market structure of the petroleum industry and the regulatory framework. Section 3 provides analytical framework and data description, while section 4 provides for empirical results. Section 5 concludes.

2.0 Background Information

The institutional structure of petroleum industry comprises the Ministry of Energy, the Energy Regulatory Commission (ERC), Kenya Pipeline Company (KPC), Kenya Petroleum Refineries Limited (KPRL) and Multinational Independent Oil Marketing Companies that include a State Oil Company, the National Oil Corporation of Kenya (NOCK). The Ministry of Energy provides the policy leadership, while ERC provides regulatory stewardship of the sub-sector.

The KPC is a State Corporation fully owned by government under the MOE. Its overall objective is to provide the economy with the most efficient, reliable, safe and least cost means of transporting petroleum products from Mombasa to the hinterland. Specifically, it runs a 450kms 14 inch pipeline from Mombasa to Nairobi and manages open access Kipevu Oil Storages Facilities and other common storage depots in the inland.

KRPL is limited company that runs a single skimming refinery in Mombasa. The government owns 50 per cent of the equity, while the difference is owned by Essar Energy Overseas Limited.

Notwithstanding the 1992 deregulation initiative, the market structure of oil industry remains oligopolistic both in whole and retail level (Government of Kenya, 2005). Approximately 85.3 per cent of market share control is by major oil companies, that is Shell/BP, Total, Kenol/Kobil, Caltex and Mobil (Government of Kenya, 2005). The major oil companies are vertically integrated with a stake of 51,4 per cent of the 1,153 retail outlets, the remaining are controlled by new entrants and independent owners (Government of Kenya, 2005).

Kenya's petroleum products are supplied from refined imported crude oil by Kenya Petroleum Refineries Limited (KPRL) and direct importation of refined products. The importation of both crude and refined products is coordinated by the Ministry of Energy through an Open Tender System (OTS). Prior to the OTS, the Ministry of Energy (MOE) allocates the base load based on the historical market share of licensed importers. The OTS winner allocates refined product based on calculated cargo participation. The cargo participation allocation is calculated by the KPRL in two months advance, taking into consideration the existing stock of the licensed importers. Data indicates that importation of crude is dominated by major oil companies (Government of Kenya, 2005). Kenya Petroleum Refineries Limited (KPRL) is owned by government and Shell/BP and Chevron/Texaco on a 50 per cent basis (Government ofKenya, 2005).

The other source of Kenya's petroleum products is imported refined products. Seventy per cent of the imported products are conducted through OTS. The remaining 30 per cent is left to the discretion of licensed importers. Unlike OTS under the crude oil, cargo participation is based on the demand of licensed importers. The imports are stored at Kipevu Oil Storage facility, which is

operated and managed by the Kenya Pipeline Company.

2.1 Regulatory Framework

This section covers the regulatory legal framework on competition focusing on provisions that deal with restrictive trade practices.

2.1.1 Restrictive Trade Practices, Monopolies and Price Control

The Restrictive Trade Practices, Monopolies and Price Control Act (hereinafter the "**RTPA**")[1] broadly seeks to encourage competition in the Kenyan economy by prohibiting restrictive trade practices, and controlling monopolies, concentrations of economic power and prices.

The RTPA came into force on 1 February, 1989. Its enactment was driven by the public policy desire to move Kenya from a price control regime to a competitive market economy. The overall intention of the RTPA was to get the Kenyan government to rely less on instruments of direct control and increasingly on competitive elements within the economy. To that end, the RTPA repealed the Price Control Act, which until then had been in existence for 33 years.

While the RTPA is due to be repealed by the Competition Act[2], it currently remains in operation until Competition Act comes into force. The considerations that have led to the enactment of the Competition Act and the imminent repeal of the RTPA, are usefully set out in a report known as "*Voluntary Peer Review on Competition Policy: Kenya*" sponsored by the United Nations Conference on Trade and Development Report, as well as a report by the former Monopolies and Prices Commissioner, Mr Peter Muchoki Njoroge.

Part II, section 4(1), of the RTPA stipulates the general rule in respect of the so-called "*restrictive trade practices*".

1. Specifically, section 4(1) defines a "*restrictive trade practice*" as:

   "*an act performed by one or more persons engaged in the production or distribution of goods or services which*

   (a) in respect of other persons offering the skills, motivation and minimum seed capital required in order to compete at fair market prices in any field of production or distribution, reduces or eliminates their opportunities so to participate; or

   (b) in respect of other persons able and willing to pay fair market prices for goods or services, either for production, for resale or final consumption, reduces or eliminates their opportunities to acquire those goods or services."

[1] The Restrictive Trade Practices, Monopolies and Price Control Act Chapter 504

[2] See Section 99 of the Competition Act

The above definition thus covers both unilateral conduct and agreements. Section 4(2) provides the test for measuring reduction or elimination of opportunities. It states that, for the purposes of section 4(1), reduction or elimination of opportunities is to be measured with reference to the situation that would pertain in the absence of the practices in question.

2.1.2 Competition Act of 2010

The objective of the Competition Act No. 12 of 2010 is to promote and safeguard competition in the Kenyan economy and bring Kenyan competition law in line with international best practice.

The Competition Act was granted Presidential Assent on 30 December 2010, and will come into force upon notice published in the Gazette by the Kenyan Minister of Finance. So far, no such notice has been given. However, the Act is likely to come into force in July this year.

Section 21 of the Competition Act contains the general rule against restrictive trade practices by prohibiting such practices, which include agreements (both horizontal and vertical agreements) between undertakings which have as their object or effect the prevention, distortion or lessening of competition in trade in any goods or services in Kenya.

In particular, section 21(1) and (2) provide as follows:

> ***21.*** *(1) Agreements between undertakings, decisions by associations of undertakings, decisions by undertakings or concerted practices by undertakings which have as their object or effect the prevention, distortion or lessening of competition in trade in any goods or services in Kenya, or a part of Kenya, are prohibited, unless they are exempt in accordance with the provisions of Section C of this Part.*
>
> *(2) Agreements, decisions and concerted practices contemplated in subsection (1) include agreements concluded between—*
>
> > *(a) parties in a horizontal relationship, being undertakings trading in competition; or*
> >
> > *(b) parties in a vertical relationship, being an undertaking and its suppliers or customers or both.*

3.0 Methodology

3.1 Data Description

The data used in this study is part of comprehensive study that was conducted by Kenya Institute for Public Policy Research and Analysis (KIPPRA) on behalf of ERC. The exercise entailed collecting secondary data available on energy products and macroeconomics variables in Kenya at the national level. Since most of the data is aggregated for the whole country with no household level data, a primary field survey was carried out to energy marketers and consumers to fill the gap.

The field survey instrument focused on key informants, product dealers, productive end users and households. A random sample size of 3,600 households was selected with 1,080 rural and the rest urban. While the population of register establishment stood at 38,670, different samples were tested to fit within the stipulated financial framework with ultimate sample on consumption being accepted as 5 per cent of all establishments. This would result in 1934 consumer establishment.

3.2 Analytical model

Given that the market structure of the petroleum industry could facilitate cartelization, we assume the oil companies behave like a cartel (Government of Kenya, 2005). This assumption is supported by the fact that petroleum products have no close substitutes; the major oil firms face similar cost structure and price deviations for cartel price at retail level.

We propose to estimate the residual demand curve of the major oil companies by mimicking the econometric technique of Baker and Bresnahan research (Baker and Bresnaham, 1988).

4.0 Results

5.0 Conclusion

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