AMCHAM KENYA

Clerk of the National Assembly
P.O Box 41842-00100
Nairobi, Kenya

September 28, 2021

Via Email:

clerk@parliament.go.ke

Attention: Michael R.Sialai

Dear Sir,

REQUEST FOR MEMORANDA ON PETROLEUM PRICING

We refer to the above subject matter.

The American Chamber of Commerce (AMCHAM) is a leading business Chamber, whose objective is to drive mutual growth and economic prosperity through increased two-way trade and investment between Kenya and the United States. AmCham Kenya has been working closely with the Kenyan government to promote closer commercial ties between our countries.

AMCHAM proudly supports the government of Kenya's ambition to negotiate a high standard, comprehensive trade agreement between Kenya and the U.S. Such an agreement has the potential to support the creation of millions of jobs, drive growth in exports for Kenyan and U.S. manufacturers, boost small businesses, power the service economy and grow digital trade.

AMCHAM's members, who include some of the largest multinational corporations have formed an Energy & Infrastructure Taskforce (Working Group) which has been considering various policies to enable the growth of Kenya's Energy & Infrastructure space.

AMCHAM is pleased to provide the attached statement for your consideration in line with the call for public and stakeholder comments.

Should you require any clarifications on our submission below, please do not hesitate to contact me at Maxwell@amcham.co.ke

Yours Sincerely,

Maxwell Okello
Chief Executive Officer

ISSUE STATEMENT ON PETROLEUM PRICING IN KENYA BY THE ENERGY & INFRASTRUCTURE TASKFORCE OF THE AMERICAN CHAMBER OF COMMERCE (KENYA)

Background

Petroleum products are a primary energy source in Kenya and constitute 25% of primary energy consumption in Kenya. They play a significant role in Kenya's economic growth as they are vital for industrial production, transportation, generation of electricity, amongst other uses. Accordingly, the importance of stable prices of petroleum products to the economy, cannot be gainsaid. Hikes in the prices of petroleum products invariably lead to general increases in prices of other essential commodities and services, which negatively impacts numerous sectors of the Kenyan economy.

Pump prices of petroleum products in Kenya have continued to rise relentlessly over the years and finally reached a high of Kshs. 134.72 for a liter of super petrol, Kshs.115.60 for a liter of diesel and Kshs.110.82 for a liter of kerosene in September 2021. The Energy and Petroleum Regulatory Authority (EPRA) has attributed the increment to changes in the average landing cost of petroleum products. Whilst international crude oil prices are the most significant factor in determining retail prices for petroleum products, besides the interaction of forces of demand and supply, policy options adopted by the Government have played a significant part in inflating retail prices.

Prior to 1994, the government, in consultation with the oil marketing companies, set consumer prices for petroleum products in the country. After 1994, procurement, distribution, and pricing of petroleum products were liberalized to attract private capital in the industry and to also enhance its operational efficiency. When international oil prices rose sharply, the corresponding domestic prices also shot up. Consumers complained that they were not reflective of the actual market prices but exhibited "rockets and feathers" pricing—as soon as the world price rose, domestic retail prices were increased, yet when the price fell, retail prices did not fall immediately and instead took time to be adjusted downward.

The government came under exceeding pressure from several consumer lobby groups to regulate the pricing of petroleum products being marketed in Kenya. Subsequently, the government in 2006, enacted the Energy Act No. 12 of 2006, which established the Energy Regulatory Commission (ERC, now EPRA) and mandated it with setting retail prices for petroleum products. In 2010, the government passed the Energy (Petroleum Pricing) Regulations, 2010 (or "the Regulations") which were aimed at, *inter alia,* stabilizing prices of specified petroleum products in Kenya and minimizing the variances in prices of specified petroleum products across the country. Consequently, ERC instituted a pricing formula to be used by oil marketing firms and the same was published in the Legal Notice No. 196 of 2010. In determining the maximum retail pump prices for super petrol, regular petrol, kerosene and diesel products, the formula considers transportation cost from Mombasa to the nearest wholesale depot, allowed loses in the pipeline and in the depot, allowed gross wholesale and retail margins among other considerations. The pricing formula continues to be applied by EPRA to date and prices are published monthly on the 15th of every month.

In April 2020, the Tax Laws (Amendment) Bill, 2020 came into force. The amendment includes taxes and levies as part of the vatable base of petroleum products. Upon its enforcement, the contribution of taxes and levies to retail prices immediately increased by 7.8 per cent for super petrol, 9.1 per cent for diesel and 1.7 per cent for kerosene. Later in July 2020, the government, through Legal Notice No. 140 of 2020, increased the Petroleum Development Levy (PDL) from Kshs. 0.40 to Kshs. 5.40 and indicated that this would go into a fund which would compensate consumers when crude prices went above $50.

Concerns

Kenya's petroleum costs are higher than those of her neighbours and competitors. Changes in petroleum prices have not followed a smooth, systematic, or predictable pattern which makes planning for the future ever more difficult. AmCham is particularly concerned that:

a. The pricing formula has failed to protect consumers from high petroleum prices. It has lowered the profitability of the oil retail business and does not in fact seem to stabilise oil prices for consumers as was intended at its inception. Particularly:

   i. EPRA relies on price of Murban crude oil, the monthly set price of the Abu Dhabi National Oil Company Price, as a basis of determining the Free on Board (FOB) price of fuel monthly under the Open Tendering System (OTS). Having this price as a benchmark FOB price to the exclusion of product prices in different locations in the world, unnecessarily limits oil marketing companies to a single source of crude or refined oil and thereby does not necessarily offer consumers the best price for the procurement of oil.

   ii. The maximum wholesale price allows for losses incurred in the pipeline and in the wholesale depot. Losses incurred in the pipeline and in the depot have to be recovered in the petroleum price charged to consumers. Kenya does not have a properly functioning refinery, and system inefficiencies in the Kenya Pipeline Company force consumers to defray incidental costs that are not, strictly speaking, part of the actual price of petroleum products. This makes it difficult to pass the benefit of fuel prices that truly reflect the true prices of petroleum products.

iii. The Regulations affixed maximum wholesale and retail margins allowed to oil marketing companies and retail dealers. The formula allows the oil marketing company's gross wholesale margin at Kshs.6.00 per litre and that for retail dealers at Kshs.3.20 per litre. Such fixed margins may not reflect market realities as operational costs may well exceed the margins fixed by the Regulations.

b. Owing to the hike in petroleum prices, electricity consumers are paying an extra Kshs. 1.2 more per unit attributed to an increase in compensation by Kenya Power to diesel plants;

c. There are now reports that the Government is looking to increase the Value Added Tax on petroleum products by an additional 8%;

d. EPRA recently validated the Draft Petroleum (Pricing) Regulations, 2020, which did not take into consideration proposals for the enforcement of the diesel subsidy;

e. Whilst the Petroleum Development Levy Order Act (1991) allows the Cabinet Secretary to impose a levy on petroleum fuels consumed, the funds collected from the levy are to be used *'as necessary for the development of common facilities for the distribution or testing of oil products and for matters relating to the development of oil industry as the Cabinet Secretary may direct'* and not for price stabilization as directed by Government when it increased the PDL in 2020;

f. In other jurisdictions, price stabilization funds have proved challenging and are being scrapped off for reasons that:
    i. when the scheme is inaugurated at a time of 'high' prices and prices are then set below the prevailing market prices, then the fund will need a substantial amount of initial financing from the government to cater for an unexpected increase;
    ii. when the basis for calculating the expected price is incorrect, then the scheme could run a persistent deficit, which would again have to be financed by the government; and
    iii. even when the "correct" expected price is identified, in that oil prices are "mean-reverting" to this level, it can take a long time for the scheme to break even. Long "runs" of higher-than-normal prices are not necessarily immediately balanced by similar runs of lower-than-normal prices, so that the duration of the time the fund spends in deficit can be surprisingly lengthy.

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Recommendations

1. Review of the pricing formula

A case study of the South African Basic Fuel Price (BFP) model for computing the maximum petroleum pump prices could draw insightful lessons for Kenya:

(a) As regards determining landed costs, the FOB (Free on Ship's Board) product prices from different locations in the world, based on international product availability and product quality are used. The Petrol FOB price is calculated at 50% of the Mediterranean spot price for premium unleaded petrol and 50% of the Singapore spot price for 95 Octane unleaded petrol. The prices of different locations used in the determination of this component enable the South African Authorities to arrive at a fairly balanced price as opposed to applying a price emanating from only one source. It also increases the latitude of availing the fuel products at the most competitive prices as opposed to single sourcing that occurs with the Open Tender System applied by the Regulations which largely rely on the Arab Gulf's fuel prices.

(b) Oil marketing companies have in the past decried the inefficient refining system in Kenya and the capacity constrained storage and distribution network operated by the Kenya Pipeline Company. A clear reason for this is that losses incurred due to the system inefficiencies are factored into the pricing formula. This means oil marketing companies, and ultimately consumers, are forced to bear the burden of system inefficiencies. It would be preferrable to base the pricing formula on purely commercial considerations. This will ensure that petroleum prices reflect actual market prices. This will also require the Kenyan government to ameliorate its transport systems and create a better and functioning refining capacity. It is noteworthy that the government has been quite engaged in improving the transport sector in Kenya and this will go a long way towards improving the petroleum sector as well.

(c) The Regulations affix maximum allowed wholesale and retail profit margins that may not reflect prevailing market situations which significantly eroded the Kenyan market for oil retail and wholesale business with multinational entities deciding to exit the Kenyan market. This was largely because the maximum allowed margins do not reflect the costs incurred by oil marketing companies. This puts consumers at risk because oil marketing companies can easily be incentivized to hoard petroleum products. The Government should consider amending the allowed wholesale and retail margin. Under the South African model, the formula used to determine the wholesale margin is based on the results of a cost/ financial investigation by a chartered accountant firm into the profitability of the wholesale marketer. The same goes for the retail margin. It based on the actual costs incurred by retail dealers in distributing petrol. Consequently, the margins are more justifiable as they are based on prevailing market situations and are not arbitrarily determined. This creates greater incentives for efficiency in how oil businesses are run. It bears noting that the Draft Petroleum (Pricing) Regulations 2020 provide for the review of the allowed wholesale margin from time to time. They also provide for a retail margin corresponding to the operation costs associated with the benchmark retail dispensing site which may be reviewed from time to time. This is a positive addition and should provide a positive response and the flexibility needed.

2. **Separate the petroleum development fund from the price stabilization fund**

If the government wishes to activate a price stabilization fund it should be set up separately from the petroleum development levy fund. Government will also need to formulate regulations on the purpose, objectives, and operationalization of both funds, together with a transparency and accountability framework as required under the Petroleum Act.

In setting up the price stabilization fund, the Government should note that many countries have set up price stabilization funds with little success. Malawi's price stabilization fund, for instance, ran up a large deficit in 2008.

3. **Limit any tax increases on petroleum products**

4. **Set prices/develop policies in consultation with the industry**

Government will need to win the public's support in whatever measures it takes to cope with fluctuating petroleum prices. This will require a great deal of transparency and public participation so that consumers are convinced of the parameters that determine petroleum prices. With the enactment of the Competition Act 2010 and the Consumer Protection Act 2012, the open tendering process should come under heavier scrutiny to ensure that pricing is conducted in a fair, transparent, and efficient manner.