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Effects of the 2013 National Elections on Oil Exploration in Kenya

Andrea S. Pongo

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Executive Summary

Expectations are high among the Kenyan public that violence related to the March 4, 2013 general elections will intensify in fiercely disputed areas of the country before then. Despite the widespread belief, international oil companies (IOCs) now performing oil and gas (O&G) exploration work in Kenya express the opinion that violence is unlikely to be directed at their facilities or personnel and will have no impact on their ongoing operations. This assumption is reasonable, given the cautious public optimism about potential economic gains from new O&G discoveries and the lack of past hostility in Kenya toward IOCs.

During recent studies, IDA researchers learned that IOCs regard security risks to their operations and personnel as manageable contingencies and a cost of doing business in less stable environments around the world. (See IDA Report: *Commercial Perspectives on Political Risk in Sub-Saharan Africa*, October 5, 2012.) One critical exception exists, however. If expatriate company personnel are killed by actors within a host country, an IOC will likely curtail its operations there.[1] Physical harm to O&G personnel is very unlikely in the context of Kenya's March 4 elections. Accidental harm to personnel or facilities is mitigated by their location in remote rural areas, far from the urban centers where violence is occurring. That said, IDA researchers who have traveled to rural areas of Rift Valley Province warn that any election-related violence could provide cover for groups planning disruptive activities for other non-political purposes, such as settling scores over land disputes or ethnic rivalries. For example, in areas where oil exploration facilities are located and where post-electoral violence is a possibility, actions against Kenyan security personnel protecting foreign installations – especially if those personnel belong to a perceived "outside" ethnic group – are a small but conceivable risk.[2]

A different risk confronts the IOCs if Uhuru Kenyatta and William Ruto win the presidential election. Their indictment by the ICC is not in itself a concern for exploration companies, who cite the binding obligations of their contracts with the Kenyan government as grounds for continuing their future work in the country. If, however, international sanctions were applied against Kenya – an unlikely outcome, given the desire of most Western governments to maintain positive relations with important African security partners such as Kenya – IOCs would be required to comply with the legal regimes of their home countries.[3]

Recent oil discoveries indicate Kenya might possess billions of barrels of reserves that could provide massive new revenue to the Kenyan government. The potential for

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OIL AND POLITICAL STABILITY

EFFECTS OF THE 2013 NATIONAL ELECTIONS ON OIL EXPLORATION IN KENYA

MS. ANDREA PONGO, PRINCIPAL RESEARCHER

FEBRUARY 8, 2013

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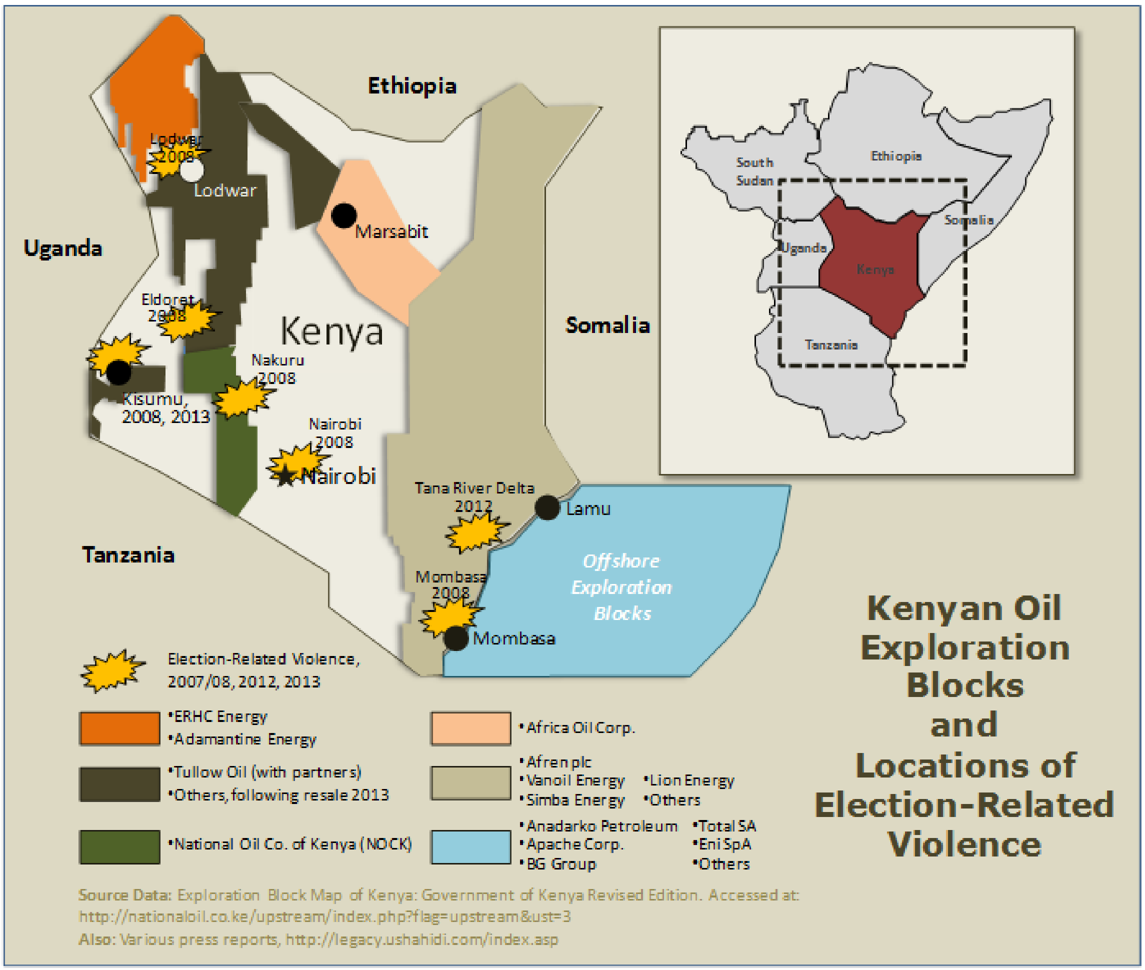
new wealth raises the stakes of political contests to decide which parties and which ethnic groups control access to Kenyan hydrocarbon resources.

Violence related to the election is already affecting economic activity in places that experienced bloodshed in 2007/08. People are moving out of Kenya's Coast Province and Nyanza Province.[4] Iron, steel, and construction companies in Kenya's third-largest city of Kisumu laid off thousands of workers in January while trying to avoid the looting and destruction they experienced five years ago.[5] Companies in Kenya have been hiring private security protection because they expect the police to be occupied with political unrest and seriously overstretched during the election period.[6]



Locations of Oil and Violence

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Effects of the 2013 National Elections on Oil Exploration in Kenya

Election Violence and Oil Exploration in Kenya

Tensions are running high in the run-up to complicated March 4 elections in Kenya, but despite the violence in fiercely disputed areas of the country, international oil companies (IOCs) express the opinion that it is unlikely to be directed at their facilities or personnel and will have no impact on their ongoing operations. They point out that violence usually occurs in urban environments – not the rural areas where exploration projects operate – and likely will be localized in cities or districts with intense electoral competitions. This assumption is reasonable, given the cautious public optimism about potential economic gains from O&G discoveries and the lack of past hostility toward IOCs. These same economic benefits, however, could provide new incentives for political leaders to compete for control of access to Kenyan resources.

Expectations of Election-Related Violence

Elections scheduled for March 2013 will decide not only the presidential race, but also races for senators, members of parliament, and 47 new county governors at the local level. Current prime minister and ethnic Luo Raila Odinga is running for president as the head of the Coalition for Reforms and Democracy (CORD) against Deputy Prime Minister Uhuru Kenyatta and former agriculture minister William Ruto – ethnic Kikuyu and Kalenjin, respectively – who lead the Jubilee Alliance. Whichever coalition wins, there is a possibility that the opposition will engage in post-election violence to achieve a power-sharing arrangement or to pressure the new leadership to agree to terms. (For example, a Raila Odinga victory could provoke supporters of the Kenyatta-Ruto ticket to press for promises not to extradite the indicted politicians to the International Criminal Court (ICC).) Pre-election violence that has already occurred is intended to achieve the displacement of political opponents, while post-election violence could be orchestrated by political leaders to alter results in hotly contested areas.

Violence related to the election is already affecting economic activity in places that experienced bloodshed in 2007/08. As of early January 2013, businesses in Kenya's third-largest city of Kisumu (home town of Raila Odinga) in western Nyanza Province announced they would suspend operations until the March 2013 election outcome was known. Iron, steel, and construction companies laid off thousands of workers in January while trying to avoid the looting and destruction they experienced five years ago.[7]

Companies in Kenya have been hiring private security protection because they expect the police to be occupied with political unrest and seriously overstretched during the election period.[8] According to former police official and security consultant George Musamali, people are moving out of Coast Province and Nyanza Province based on their fear of election-related violence.[9]

Violence did break out in Kisumu on January 19 and 20 when primary election results were disputed. Local press reported that an election official died of stab wounds received during the violence.[10] The January chaos echoed the violence, looting, and vandalism that occurred in 2007/08 between gangs of Luo and Kikuyu ethnic groups in Kisumu.[11] Tensions were already high after police responded to protestors with live fire and tear gas following the detention of one candidate on January 15 whom police accused of hoarding weapons.[12] Press reports proposed that violence after the primaries was a preview of things to come in March 2013 after what IDA expects will be the first round of national voting.[13]

Elections and Oil

Since the electoral violence that occurred in 2007/08, the discovery of potentially vast oil and natural gas resources in Kenya – particularly in Rift Valley Province in the north and off the Coast Province littoral in the south – has created new and strong incentives for winning political control of the regions in question. Kenyan government officials are responsible for the granting of lucrative licenses to IOCs. Big projects – including the proposed oil pipeline from Kenya's northwest borders to the coast and the $20 billion Lamu Port-South Sudan-Ethiopia Transport Corridor (LAPSSET) pipeline, refinery, and transport facility near Lamu – will provide big earnings for politicians who control the area. Figure 1 shows the proposed route that the LAPSSET project might take.

Going forward, political leaders could solidify existing political support or earn new political support among the local population if they are seen to be delivering the community-level benefits required of IOCs operating in Kenya. Corrupt politicians will have access to large flows of funds that result from investment projects and local content requirements. The 2003 Public Officer Ethics Act in Kenya has no prohibition against civil servants owning stakes or having any other interest in a private company unless "holding those shares or having that interest would result in the public officer's personal interests conflicting with his official duties."[14] The Act states that "a public officer shall use his best efforts to avoid being in a position in which his personal interests conflict with his official duties."[15] Businesses connected to these politicians can also benefit from the programs.

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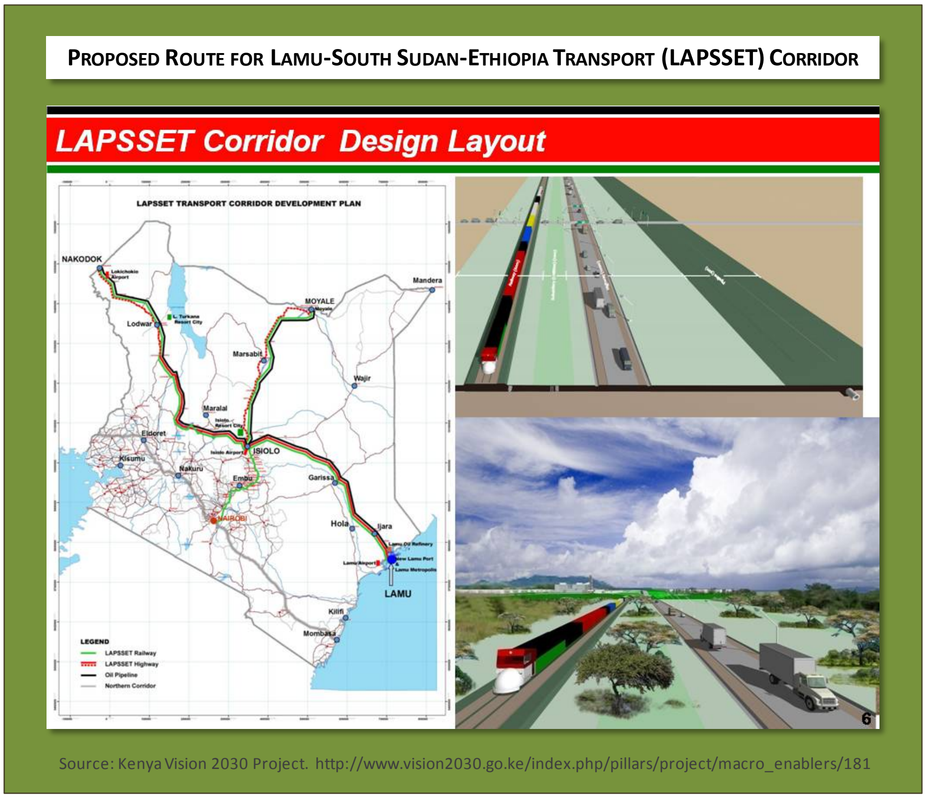

Figure 1. Proposed Pipelines across Kenya

While it is not currently a part of the public discourse among political leaders, the importance of maintaining stability in order to attract and keep O&G investment could become a political issue in the future. If the Kenyan public comes to see the IOCs as beneficial for the country's development, there is a chance that O&G exploration could help to mitigate future political violence in resource rich areas.

According to IOCs currently performing exploration projects in Kenya, election-related violence is not expected to disrupt their ongoing operations. Some IOCs contacted by IDA are not currently active in the regions at the highest risk of violence or do not have personnel at risk.[16] IOC executives cite the fact that none of the recent outbreaks of violence in the run-up to elections have been directed at oil exploration work, IOCs, or IOC personnel.[17] They point out that protests and violence usually occur in urban environments and less often in rural ones and express the expectation that election-related violence will be localized in certain cities or districts, depending on the intensity of the political contest there. The January 19 and 20 violence in Nyanza Province had no effect on IOC activities there, and the Turkana District in Rift Valley Province is not seen by IOCs as particularly risky.[18]

A different risk confronts IOCs if Uhuru Kenyatta and William Ruto win the presidential election. Their indictment by the ICC is not in itself a concern for exploration companies, who cite the binding obligations of their contracts with the Kenyan government as grounds for continuing their future work. If, however, international sanctions were applied against Kenya – an unlikely outcome, given the desire of most Western governments to maintain positive relations with important African security partners such as Kenya – IOCs would be required to comply with the legal regimes of their home countries.[19]

There is a small possibility that IOCs might underestimate the security risks in Rift Valley Province or be unaware of the existing tensions on the ground in the region. Local ethnic groups have been acquiring weapons at an increasing rate for the past 30 years.[20,21,22] Traditional cattle raids among pastoralist groups have become systematized and militarized – and, consequently, more deadly – as crime bosses organize raiding parties, provide more and better weapons, and then profit from the raids. A key example of this danger was the November 2012 Baragoi massacre that took place in Samburu District. The result of a failed operation was that 42 ill-prepared Kenyan police personnel were killed by an overwhelming force of up to 1,000 well-armed bandits when they tried to quell violent cattle raiding in the area.[23,24] Across rural Kenya, disputes between farmers and herders and between various herder communities over land use and access to water frequently erupt into violence. New facilities being acquired and demarcated by foreign companies in the midst of these ongoing struggles for territorial access could potentially instigate new tensions.

IDA researchers who have traveled to rural areas of Rift Valley Province warn that, if violence erupts there as a consequence of electoral outcomes after March 4, there is a chance it could provide cover for other groups planning disruptive activities for their own non-political purposes. In areas where oil exploration facilities are located and where post-electoral violence is a possibility, actions against Kenyan security personnel protecting foreign installations – especially if those personnel belong to a perceived "outside" ethnic group – are a small but conceivable risk.[25]

Background: 2012 Kenyan Oil Discoveries

When the first major oil discovery in Kenya was announced on March 26, 2012, industry watchers predicted that East Africa could become one of the most important regions for new oil discoveries in decades. Analysts project that $300 million will be spent on O&G exploration activities in Kenya in 2013.[26] If managed well, revenues from oil and gas production could cause rapid economic growth in Kenya. If managed poorly, the new source of wealth would likely enrich only a small, corrupt elite that would control access to hydrocarbon resources. Worse still, the growing presence of foreign entities in less stable rural regions of the country where oil seems to be most plentiful will exacerbate existing disputes over access to land and water among traditional farming and herding communities.

In order to manage its potentially game-changing resource wealth, the Kenyan government must quickly develop its legislative infrastructure for regulating the oil and gas sector. Initial exploration contracts were based on a model production sharing agreement (PSA) drawn up by the Ministry of Energy in 2012.[27] Under its terms, the Kenyan government would receive an initial 10 percent share of any petroleum produced from successful exploration and production projects. The government share would then increase by annual increments to a final share of 70 to 80 percent of petroleum produced.[28] Western exploration companies are contributing millions of dollars of upfront capital to explore the licensed blocks and to develop any commercially viable fields. In addition, the various PSAs concluded with IOCs require training programs and jobs for members of surrounding communities, as well as percentages of the project cost to be spent on corporate social responsibility (CSR) projects.[29] The government also receives one-off fees of approximately $1 million for each license sold.[30]

Kenya is not currently a member of the Extractive Industries Transparency Initiative (EITI), which seeks to promote a global standard of revenue transparency at the local level.[31,32] Under the EITI standard, IOCs would disclose the payments they made to acquire assets, and the government would voluntarily disclose the amounts of payments from companies. Pressure from outside actors might not be enough to persuade Kenyan political leaders to adopt EITI standards if other oil-producing countries in East Africa resist, despite the comparative advantage that adoption could provide to Kenya.

There are a limited number of experienced O&G exploration companies currently operating in Kenya. The largest operator in terms of acreage is Tullow Oil Plc (UK), which has partnered with several other companies active in East Africa including Africa Oil Corp. (Canada), Afren Plc (UK), Total SA (France), and CNOOC (China). Anadarko Petroleum Corp. (U.S.) and Apache Corporation (U.S.) are mainly exploring offshore blocks for natural gas and oil. Major oil discoveries in Kenya were made only in 2012, and exploration activities are in their early days. At this time, the IOC footprint is relatively small in areas of active exploration (see Figure 2). No new infrastructure, such as pipelines or refinery capacity, will be built until it is certain that the oil found is commercially viable.

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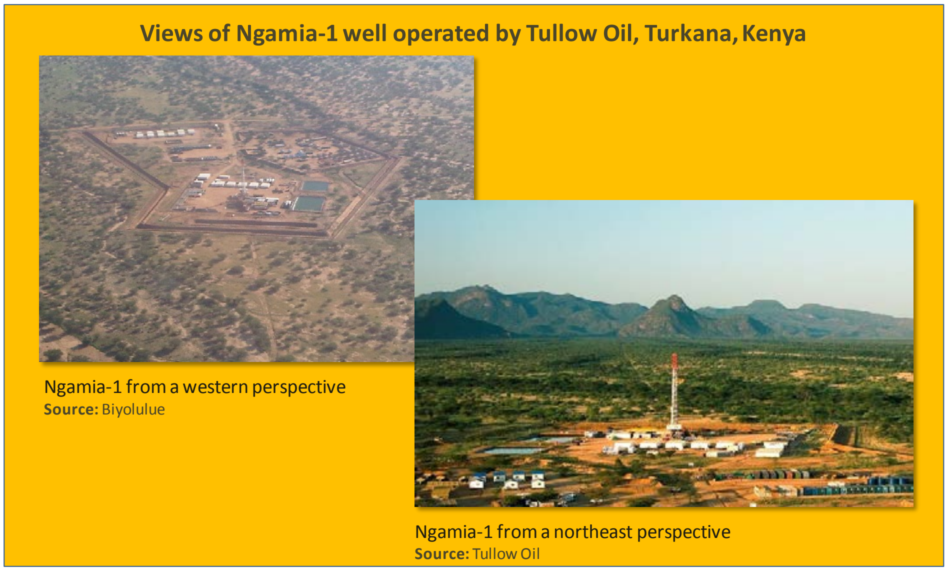

Views of Ngamia-1 well operated by Tullow Oil, Turkana, Kenya

Ngamia-1 from a western perspective
Source: Biyolulue

Ngamia-1 from a northeast perspective
Source: Tullow Oil

Figure 2. Ngamia-1 in Turkana

In November 2012, Kenyan press began reporting that the usual PSA terms were being reconsidered by officials. The government require not only initial shares of 20 percent of petroleum produced, but also ownership stakes of 25 percent in new exploration projects, if the exploration firm failed to work the site in the agreed time period in the latter case.[33] According to the Energy Permanent Secretary Patrick Nyoike, exploration companies are now expected to surrender 25 percent of the original contract area of land at the end of the initial three-year contract term and another 25 percent at the end of the standard two-year extension of the contract.[34]

In the very fast-moving and highly competitive environment of Kenyan oil exploration, new and dramatic changes to the terms of agreements could irritate the investor community. As shown in Figure 3, even though commercial risks can be managed by large IOCs (unlike geological or compliance risks), they are critical to the decision to invest in a given host country. Predictability and the sanctity of contracts are essential to O&G exploration, development, and production. If the government resulting from March elections signals that contracts are subject to unilateral renegotiation, subsequent investors could focus their main energies elsewhere in East Africa for large development and production opportunities, which usually require billions, not millions, of investment dollars.

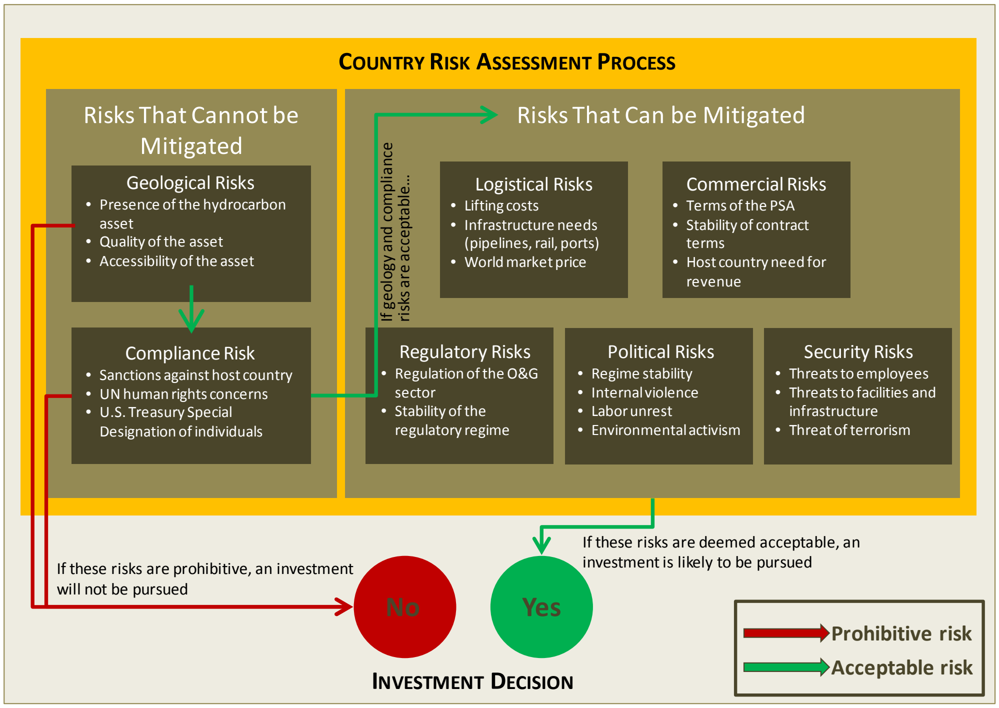

Figure 3. IOC Risk Assessment Process

Nonetheless, Kenya offers advantages that make it preferable to neighboring states for O&G exploration. For example, although its infrastructure is woefully inadequate, the existence of ports along the Kenyan coast – to which oil could be transported from the Rift Valley by pipeline or rail and from which oil and eventually refined products could be shipped to world markets – make Kenya more desirable than land-locked Uganda to the west or Ethiopia to the north. In addition, the government of Yoweri Museveni in Uganda has made doing business there difficult. In December 2012, Tullow Oil registered a new tax dispute with Uganda over an 18 percent value-added charge on imported machinery.[35] In 2010, Heritage Oil fought back against a 30 percent capital gains tax levied after its $1.45 billion asset sale to Tullow Oil.[36] Museveni's insistence on building Ugandan refinery capacity at IOC expense has delayed the production of its oil resources. Ethiopia has no port from which oil can be directly shipped out of the country and Somalia is still struggling to establish functioning government institutions.

Conclusions: Oil and Gas Exploration Unaffected by Elections

Recent oil discoveries indicating that Kenya could possess billions of barrels of reserves could provide massive new revenue to the Kenyan government. The potential of new wealth raises the stakes of political contests to decide which parties and which ethnic groups control access to Kenyan hydrocarbon resources. No matter which political coalition is successful after the voting on March 4, 2013, IOCs will continue their exploration work in Kenya, pursuing billions of units of oil and natural gas. IOCs are more concerned about the risk that their home governments would take action against a

Kenyan government led by individuals under indictment by the ICC than about the risk of election-related violence affecting their operations.

Predictability and the sanctity of contracts are critical to O&G investment. During 2013, the government of Kenya will update its outdated laws regulating the O&G sector and announce new terms governing IOC and government shares of future oil production. If the next Kenyan government goes the way of the Museveni government in Uganda by making unilateral demands that undermine the commercial viability of O&G projects, subsequent investors could focus their main energies elsewhere in East Africa. That said, Kenya offers geographic advantages that make it preferable to neighboring states for O&G exploration. Unlike landlocked Uganda and Ethiopia, Kenya's long coastline provides the potential for new and expanded port facilities from which extracted oil can be shipped to world markets. If the currently inadequate infrastructure can be upgraded and expanded at a rational cost, Kenya could become the most important energy hub in East Africa.

If serious violence follows the March 4 vote, political uncertainty could undermine near-term investment in Kenyan O&G exploration. In the longer term, however, investment would recover if the quality and commercial viability of Kenyan hydrocarbons are as favorable as initial results suggest. During the next decade, it is likely that issues related to oil revenue distribution will become essential to the national political debate.

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Endnotes

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14. ABSTRACT

An analysis of risks to international oil company (IOC) operations in Kenya during the run-up to Kenyan national elections, scheduled for March 2013. The study discusses conditions in Kenya as of February 2013 and assesses the risk of electoral violence to oil exploration projects. The report includes primary source research derived from interviews with IOC executives.

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