SUB-NATIONAL PAYMENTS IN KENYA'S OIL INDUSTRY

OXFAM KENYA DISCUSSION PAPER

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INTRODUCTION

This paper aims to give an overview of revenue benefit sharing in the context of Kenya's oil development in Turkana. It outlines the importance of revenue sharing; what the different proposed formulas may mean with respect to the cash value of transfers to sub-national levels; assesses absorptive capacity of Turkana county as this has been put forward as justifying the proposed revenue sharing formula as contained in the current Bill and concludes with recommendations for both national and county governments. The paper also seeks to shift and broaden the discourse on revenue sharing from solely focusing on revenue formulas to encompass aspects related to governance and the administration of sub-national payments, once they have been made.

The discovery of extractive resources almost always brings with it expectations for windfall revenues and socio-economic transformation. However, the potential to generate significant revenues from oil and gas resources also brings with it the prospect of conflict in relation to the sharing of revenues. Communities that live adjacent to extractive resources often bear a disproportionate burden of the costs related to resource extraction and, on this basis, argue that they should get a bigger disproportionate share of the revenues generated thereof. This 'cost' burden related to resource extraction includes involuntary displacement and resettlement, loss of land and grazing, loss of livelihoods and environmental degradation. This cost burden tends to be highly localised lending credence to calls for a higher share of sub-national revenue sharing.

Meanwhile, national governments are often averse to a disproportionate sharing of extractive resource revenues with host local governments and communities. It is often argued that local communities and or their local governments do not have the capacity to manage windfall revenues that may hugely exceed their current national budget allocations. In addition, national governments also assert that extractive resources, while having been discovered in a geographic and administrative locale- do not necessarily and solely belong to that locale- but remain national resources. The benefits from these resources should, therefore, be aggregated as part of the national treasury purse and distributed using already established revenue sharing formulas.

Increasingly, however, there is acceptance that the communities from where petroleum and mining resources are extracted should get more of the revenue and related opportunities such as jobs and local content. Sub-national revenue sharing is often made more imperative as extractive resources are often discovered in regions that are undeveloped and already lagging on various human development indicators such as access to health, education and water and sanitation. Against this background, it is, therefore, not surprising that one of the more contentious issues around the management of Kenya's petroleum resources has been on national and sub-national revenue sharing.

UTILITY OF EXTRACTIVES REVENUE SUB-NATIONAL PAYMENTS

Addressing Inequality- Subnational revenue payments could be used to address regional inequalities within a country. The exploitation of extractive resources and the uneven or disproportionate distribution of revenues considering where the resource is exploited and regional inequalities is an opportunity to even-out development outcomes across regions and or districts. In the case of Kenya, oil was discovered in Turkana where the poverty rate is one of the highest in the country at 94.3 percent[1], education is

[1] Kenya National Bureau of Statistics and Society for International Development (2013). Exploring Kenya's Inequality: Pulling Apart or Pooling Together: Turkana County, p.12.

limited as 82 percent of residents have no formal education, 15 percent have some primary education, and just 3 percent have secondary education.[2] Incomes are low: only 5.6 percent of people have paid employment.[3] In addition, Turkana is consistently impacted by drought related disasters. In such a context, sub-national revenue transfers provide an opportunity to address poverty and support social protection in the county.

Articles 202 and 203 of the Kenyan Constitution detail how national revenue should be equitably shared. They provide that revenue raised nationally shall be shared equitably among the national and county governments and that in sharing of revenue there shall be consideration for fiscal capacity and efficiency of county governments, the developmental needs of counties, the economic disparities within and among counties and the need to remedy them; and the need for affirmative action in respect of disadvantaged areas and groups. The need to address inequality and regional disparities is, therefore, espoused in Kenya's supreme law.

Managing Conflict- The transfers of oil revenues to host communities could also be useful in addressing latent or existing conflicts. The different tribes inhabiting the Karamoja Cluster[4], including the Turkana, Pokot, Karamojong, Toposa, Nyangatom and Didinga, have historically been in regular conflict over water, pasture and livestock. These traditional conflicts are increasingly violent resulting in deaths, injury and property destruction, but also limit the mobility of people and livestock that is crucial to the pastoral lifestyle.[5] Recurrent droughts and under-development have contributed to a disillusionment with national government and the sense within the community that the county has been neglected for decades, hence the high poverty levels.

Commercial development of oil resources in Turkana, could serve as a double-edged sword in that it could exacerbate pre-existing conflict as community members compete for benefits and resent 'non-Turkanas' for benefiting from jobs and local content related contracts.[6] Conversely, a widely-accepted revenue sharing formula and consistent transfers could ensure that conflict is mitigated as the county government and local community can begin to leverage these resources to improve living, social service delivery and general development outcomes.

Consolidating Devolution- In 2013, Kenya transitioned from a centralized to a devolved system of government. This entailed the creation of 47 political and administrative counties, each with an elected county government and county assembly. These new counties are endowed with significant political power and budget allocations.[7] Article 174 of the Kenya Constitution states the objects of devolution as including; promoting accountable exercise of power, enhancing public participation in the exercise of state power, protecting and promoting the interests of minorities and marginalized groups, ensuring equitable sharing of national and local resources throughout Kenya.

Effecting extractive revenue transfers to sub-national governments consolidates devolution as decentralization is essentially about devolving power, resources and representation down to the local

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https://www.knbs.or.ke/exploring-kenya-s-inequality-pulling-apart-or-poolingtogether/?option=com_phocadownload&view=category&id=114:exploring-kenya-sinequality&Itemid=599

[2] Kenya National Bureau of Statistics and Society for International Development (2013). Exploring Kenya's Inequality: Pulling Apart or Pooling Together: Turkana County, p.12.
https://www.knbs.or.ke/exploring-kenya-s-inequality-pulling-apart-or-poolingtogether/?option=com_phocadownload&view=category&id=114:exploring-kenya-sinequality&Itemid=599

[3] Ibid

[4] The Karamoja Cluster refers to the area along the South Sudan, Ethiopia, Kenya and Uganda borders.

[5] Cordaid, 2015, Oil Exploration in Kenya: Success Requires Consultation. Assessment of Community Perceptions of Oil Exploration in Turkana County. Pg 16
https://www.cordaid.org/media/medialibrary/2015/09/Turkana_Baseline_Report_DEF-LR_Cordaid.pdf

[6] G.Lynch, 2017, Turkana has to deal with challenges that have come with devolution and oil, Daily Nation, 17 February 2017 https://www.nation.co.ke/oped/opinion/gabrielle-lynch-turkana-deal-challenges-devolution-oil/440808-3817478-r175cbz/index.html

[7] Cordaid, 2015, Oil Exploration in Kenya: Success Requires Consultation. Assessment of Community Perceptions of Oil Exploration in Turkana County. Pg 17
https://www.cordaid.org/media/medialibrary/2015/09/Turkana_Baseline_Report_DEF-LR_Cordaid.pdf

level. Devolution is entrenched where county governments and local communities get a share of and preside over oil revenues as accountability and representation become more localized.

Sub-national revenue management can help democratize natural resource revenue management and expenditure, if county governments implement strategies for effective public participation in decision making on how revenue is managed. To the degree that the subnational scheme helps improve citizen engagement and participation in natural resource revenue management, the scheme could be preferable to central level management and could, fundamentally consolidate devolution.

Addressing the Negative Impact of Extractives- Extractive resource exploitation is inherently destructive of the environment and has other negative externalities. Oil exploration and development alters the community landscape and invariably changes community land-use patterns. Extractive projects may also result in involuntary displacement of communities and the acquisition of community land in addition to social disruption.

While there are funds that are normally reserved for environmental redress in cases of pollution or land reclamation; and compensation of communities in the case of displacement- there is general acceptance that the community where a resource is discovered, will have its way of life disrupted in some shape and form including in many ways that cannot be monetarily valued.[8] Sub-national revenue payments are often in recognition of this 'disruption'.

KENYA'S PROPOSED REVENUE SHARING MODEL

Kenya's Petroleum Exploration and Production Bill looks set to passed in 2018 before the kick-off of the Early Oil Pilot Scheme (EOPS) which Tullow estimates will begin in the first quarter of 2018. Discussions around a Kenya Petroleum Bill, which is meant to replace the Petroleum (Exploration and Production) Act, CAP 308- 1984 revised edition, began in 2015 but have dragged on, in part, due to contestations around sub-national revenue sharing. There have been fierce debates on what the counties should get as a share of oil revenue once Kenya reaches first oil. The Bill was reintroduced in Parliament in February 2018 and proposes the following revenue sharing model under Section 85-

85(1) The national government share of the profits derived from upstream petroleum operations shall be apportioned between the national government, county and the local community.

(2) The county government's share shall be the equivalent to 20% of the national government's share; provided that the amount allocated in accordance with this subsection shall not exceed the amount allocated to the county government by Parliament in the financial year under consideration.

(3) The local community's share shall be equivalent to 5% of the government's share and shall be payable to a trust fund managed by a Board of Trustees established by the county government in consultation with the local community:

Provided that the amount allocated in accordance with this section shall not exceed ¼ of the amount allocated to the county government by Parliament in the financial year under consideration.

(4) The respective county government shall legislate on the establishment of the Board of Trustees and the prudent utilisation of the funds received under this section for the benefit of present and future generations.

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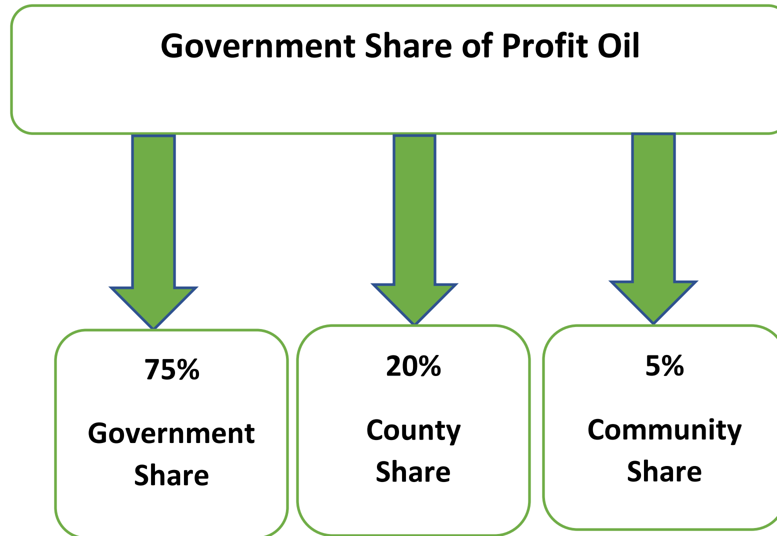
[8] A. Bauer et al, 2016, Natural Resource Revenue Sharing, NRGI and UNDP http://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/nrgi-undp-natural-resource-revenue-sharing.html pg24



There may be arguments on the actual revenue sharing formula but Kenya has settled on a derivation-based system, where extractive revenues are transferred to counties or the sub-national level based on geographic location of the production or actual extraction. In these systems, revenues are generated locally, collected by central government, and then dispersed back in some fraction to the mineral producing jurisdictions. The main rationale that was given by the Presidency for revenue sharing formula proposed in the Bill is that a capped formula would ensure that the revenue accruing to county governments and the local community is not disproportionately high as they may struggle with absorptive capacity.[9] It is likely that the Presidency consulted the Commission on Revenue Allocation (CRA) with respect to this revenue sharing formula. Article 216 of the constitution of Kenya provides for the CRA to make recommendations concerning the basis for equitable sharing of revenues raised by national government including between national and county governments. In this regard, it may be prudent for the CRA to disclose the full rationale behind the proposed revenue sharing formula in the Petroleum Bill. This would align with the CRA's contemporary full disclosure of the factors and weighting behind the current national revenue sharing formula.

Based on the revenue sharing formula proposed in the Bill, it is not clear whether the county government allocation should go into a special fund as well or if the full share is to be appropriated and or absorbed as part of the annual county budget share. In addition, the Presidency and or government has not provided adequate justification for capping beyond stating that there are concerns around absorptive capacity. Given that there are serious contestations on the discussion around revenue splitting and capping, it would be important to provide sufficient evidence to support the concerns that counties would struggle to manage additional revenue from oil production. This evidence, be it from the CRA or the Presidency, is currently missing. As will be shown under the section on *Absorptive Capacity and Compliance with Fiscal Rules,* Turkana county has done reasonably well in absorbing the current allocation from national treasury.

[9] K. Senelwa, 3 January 2017, The East African, Row Brewing Over How Turkana Oil Revenue Will be Shared, http://www.theeastafrican.co.ke/business/Row-brewing-over-how-Turkana-oil-revenue-will-be-shared/2560-3505470-sqvlpd/index.html

COUNTER-PROPOSED FORMULA

Turkana leaders have counter-argued against the proposed revenue sharing model and have been pushing for 20% of government's share to go to local counties and 10% to go to local communities. Local leaders led by the Governor of Turkana and other county executives argue that a lesser share would result in the continued marginalisation of Turkana by successive governments.[10]

Local leaders have argued that the President's concerns that county governments and the local community do not have the capacity to manage oil funds do not provide the basis for government to withhold the revenues that county leaders argue is due to them.[11] In other words, the view is that reforms should not be abandoned solely on the basis that they are capacity demanding. There may equally be capacity concerns with respect to whether national government can effectively manage windfall oil revenues. The government at both national and county level would still need to build up its capacity to effectively manage oil revenues.

ANALYSIS OF PROPOSED REVENUE SHARING MODELS

The animated arguments relating to the proposed revenue sharing models have revolved around percentages on the revenue sharing formulae and have largely not been a result of financial modelling of the Turkana oil project. The Kenya Civil Society Platform on Oil and Gas (KCSPOG)[12] and Oxfam in Kenya commissioned research pieces[13] that forecast oil revenues from the Turkana fields along with what would be due to local counties under the proposed Bill. An analysis of the potential dollar values of the proposed revenue sharing formula helps ensure that the debate around absorptive capacity and other capacity constraints is not abstract but grounded in an understanding of the actual potential cash value of the percentages.

The potential revenues from Turkana oil are based on the fiscal terms drawn from publicly disclosed PSCs[14] and base case assumptions with respect to recoverable oil reserves, oil price and cost of developing the Turkana South Lokichar Basin oil fields focusing on Blocks 13T and 10BB. The figures are, therefore, not definite but they do provide a glimpse of what could potentially accrue to national and subnational governments should the assumptions hold true (***see detailed Notes on updated base case assumptions pg15***).

Tables 1 and 2, below, show what is likely to accrue to Turkana County based on different oil price scenarios. The $65 column is highlighted as, at the time of publication, the Brent oil price is currently hovering at $65/bbl, thereby making it the most applicable base case assumption in terms of oil price. Table 1 shows the revenue split between national government, county government and the local

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[10] The East African, 3 January 2017, *'Row brewing over how revenue from the Turkana Basin will be shared'* http://www.theeastafrican.co.ke/business/Row-brewing-over-how-Turkana-oil-revenue-will-be-shared/2560-3505470-sqvlpd/index.html

[11] Ibid

[12] KCSPOG, 2016, Potential Government Revenues from Turkana Oil, discussion Paper, http://kcspog.org/wp-content/uploads/2016/04/Revenues-from-Turkana-Oil-April-2016.pdf

[13] Oxfam, 2016, Potential Petroleum Revenues for the Government of Kenya: Implications of the Proposed 2015 Model Production Sharing Contract https://kenya.oxfam.org/sites/kenya.oxfam.org/files/file_attachments/Potential%20Petroleum%20Revenues%20for%20the%20Government%20of%20Kenya.pdf

[14] Although the PSCs for Blocks 10BB and 13T remain confidential, there are seven Kenyan PSCs in the public domain including Blocks 1, 2B, 11A, L1B, L16, L27, and L28. In addition, companies have provided investor summaries of the core PSC fiscal terms for Blocks 9, 10A, 10BA, 11A, and 12B. An analysis of the fiscal terms applying to the blocks listed above suggests that there is only modest variation in fiscal terms. (KCSPOG, 2016, Potential Government Revenues from Turkana Oil, discussion Paper)

community using the revenue formula proposed in the Petroleum Bill while Table 2 shows the split based on what Turkana county leaders have been advocating for and based on a Petroleum Bill that the President refused to assent to.

The annual budget for the Turkana County government is between Kshs11-13 billion and transfers from the National Treasury have been about between Kshs10-11 billion annually. The cap as set out in the draft bill would be reached at both $65/bbl and $85/bbl during peak years of production.

Table 1- Sub-National Revenue Transfers (Kshs billions)

	2022			2027			2032		
	$45	$65	$85	$45	$65	$85	$45	$65	$85
Total Revenue	**28**	**43**	**61**	**64**	**99**	**253**	**39**	**101**	**161**
National (75%)	21	32	46	48	74	189	29	76	121
County (20%)	6	9	12	13	20	51	8	20	32
Communities (5%)	1	2	3	3	5	13	2	5	8

Source: KCSPOG[15]

In the initial oil production period, with the current proposed revenue sharing model, it is likely that county governments will hit the proposed cap only at $85/bbl while throughout the peak period, the cap would be reached at all the different price scenarios. What this means is that at peak production period- 2027- the county government could expect to get almost double the current transfers of Kshs$10-$11 billion if the oil price is at $65/bbl. The community cap in the current Bill is proposed at 5% if this does not exceed ¼ of the National Assembly transfers to county government. With current transfers of about Kshs$11billion, the community cap represents about Kshs$3billion. The community share would hit the cap in all the different price scenarios during the peak production period and in the initial production period only at $85/bbl. The proposed cap- of not more than equivalent transfer from National Assembly for the county and ¼ of the county transfer from National Assembly- will highly likely come into play with respect to sub-national payments particularly during peak production.

The proposal to cap the revenue allocation to county and community level, though not sufficiently supported by data or evidence is provided for in Kenyan national law. Article 202 (2) of the constitution states that county governments may be given additional allocations from the national government's share of the revenue *either conditionally or unconditionally*. The cap, benchmarked against already existing revenue sharing and or allocations from National Assembly represents a conditionality. In any case, Treasury already circumscribes certain transfers to county governments based on conditionality. This is particularly so for transfers from funds sourced from development partners.[16]

[15] KCSPOG, 2016, Potential Government Revenues from Turkana Oil, discussion Paper, http://kcspog.org/wp-content/uploads/2016/04/Revenues-from-Turkana-Oil-April-2016.pdf pg19

[16] County Allocation of Revenue Act No.23 of 2017, Third Schedule- Conditional Allocations to County Governments from Loans and Grants from development Partners FY2016/2017 and FY2017/2018 http://kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/CountyAllocationofRevenueAct_No23of2017.pdf pg14

Table 2 Sub-National Revenue Transfers (Kshs billions)

	2022			2027			2032		
	$45	$65	$85	$45	$65	$85	$45	$65	$85
Total Revenue	**28**	**43**	**61**	**64**	**99**	**253**	**39**	**101**	**161**
National (70%)	17	26	37	38	59	152	23	61	97
County (20%)	6	9	12	13	20	51	8	20	32
Communities (10%)	3	4	6	5	10	25	4	10	16

Source: Own/Adapted from KCSPOG Research

Under the revenue sharing model proposed in the Bill that was not assented to (Table 2), the share to the county level does not change. However, the share to the communities increases noticeably to more than double in the peak period at $65 or $85/bbl thus going beyond the cap significantly.

At peak oil production, the Turkana county government could potentially be receiving more than double the current county budget. This additional revenue in-flow could place a huge burden on the county government in terms of fiscal management. The challenge may be particularly acute at community level where community members are having direct control over the management of revenues that run into the billions of shillings under the framework of enabling legislation promulgated by the county government and the establishment of a community based Board of Trustees (BoT).

It is important to note, however, that the concerns around absorptive capacity need not result in a reduction of the percentage of revenue due to the County governments and the local community. In the contrary, concerns around absorptive capacity should enable planning for capacity reforms at national and county government levels; and provision of support for effective oversight and prudent monitoring of the transfers and use of sub-national payments. It is worth noting that the devolved system of governance in Kenya was only made operational in 2013 and counties are not more than five years old. Counties had no prior experience of managing billions of dollars in Kenyan shillings but some, such as Turkana have done this reasonably well. It is worthwhile to note that counties like Turkana have since developed governance and financial systems that position them well to effectively manage an increase in annual revenue allocations. In this sense, capping may be more important for the community level where there are currently no systems in place to handle finance, procurement, logistics and other aspects that come with managing billions of dollars in revenue in-flows.

ABSORPTIVE CAPACITY AND COMPLIANCE WITH FISCAL RULES

The auditor general's reports provide important insight into the discussion on absorptive capacity at county and community level. The auditor-general has the mandate to audit and report on the accounts of the National and County Governments under Article 229 of the Constitution and the Public Audit Act, 2003. Further, the Constitution of Kenya and Section 107 of the Public Finance Management Act, 2012 require the County Treasury to enforce fiscal responsibility principles in the management of the County Government's public finances.

Section 7 of the Public Audit Act states that the auditor general has the authority to give assurance on the effectiveness of internal controls, risk management and overall governance at national and county Government. The Act further provides that the auditor general must confirm whether public money has been applied lawfully and in an effective way; and be satisfied that all public money has been used and applied to the purposes intended and that the expenditure conforms to the authority for such expenditure.

Analysis of the Auditor General Reports for Turkana from 2014- 2016 shows that there has been under-expenditure of budgeted funds. As shows in Tables 4 and 5 below; for the FY14/15 the under-expenditure was 22.8% while for the following financial year 15/16 it had decreased to 17% as demonstrated in Table 5. Table 3 shows the budgetary allocations for development and recurrent expenditure and the absorption rates for the same. It clearly shows that the absorption rate has been more than 70%. Tables 3 and 4 clearly show that even where there is under-absorption, this has been concentrated in 'recurrent expenditure' budget lines as opposed to development spending. Equally important, is the fact that more Turkana county has allocated and expended 70% of its budget towards development expenditure and 30% towards recurrent expenditure. This revenue split between development and recurrent expenditure is an important aspect of analysis as Section 107 of the Public Finance Management Act of 2012 requires that county governments allocate a minimum of 30% of their budgets to development expenditure. As the law requires that a minimum of 30% of county budgets be allocated for development expenditure, the Turkana county government has shown financial probity and judicious management of resources by having the allocation to development expenditure at 70%.

Table 3

Item	Approved Budget 2014/2015 Kshs	Actual Expenditure Kshs	Absorption Rate	% of total expenditure
Development	9,740,507,209	7,247,580, 142	74	70
Recurrent	3,795,166,828	3,167,413,165	83	30
Total	13,535,647,037	10,414,993,307	77	100

Source: Auditor General report for Turkana County July 2014 to June 2015

Table 4

Under-Expenditure

Expenditure Category	**Budget 2014/2015 Kshs**	**Actual Expenditure 2014/2015 Kshs**	**Under Expenditure**	**Under-Expenditure as % of budgeted amount**
Compensation of Employees	1,669,142,770	1,621,687,319	47,455,451	2.8
Use of Goods and Services	1,471,214,708	1,408,639,905	62,574,803	4.3
Other Grants and Transfers	1,354,546,737	1,041,046,018	313,500,719	23.1
Social Security Benefits	38,493,654	32,584,804	5,908,850	15.4
Acquisition of Assets	7,962,401,499	5,535,947,747	2,426,426,752	30.5
Other Payments	123,451,122	104,501,137	18,949,985	15.4
Total	**12,619,250,490**	**9,744,433,930**	**2,874,816,560**	22.8%

Source: Auditor General report for Turkana County July 2014 to June 2015

For FY15/16 the Turkana County approved budget was Kshs 13,383,307,695. The county received Kshs 12,124,833,581.00 from the Equitable National Income from National Treasury. The total expenditure FY15/16 amounted to Kshs 10,238,157,312.71 comprising of Kshs 1,814,916,338 for recurrent and Kshs 8,423,240,974.26 for development.[17] The budgetary allocation towards development expenditure for FY15/16 represented 69% of the total budget. As aforementioned, the under-absorption for the total budget was 17%.

[17] Auditor General Report for Turkana County July 2015 to June 2016

Table 5

Item	Approval Budget 2015/2016	Actual Expenditure 2015/2016	Under-Absorption	Under-Absorption %
Development Expenditure for 2016	9,352,950,350	8,423,240,974	929,709,376	10%
Recurrent Expenditure for 2016	4,181,751,068	1,814, 916, 338	2,316,834,730	56%
Total	**13,484,701,418**	**10,238,157,312**	**3,246,544,106**	17%

Auditor General's Report – Turkana County July 2015- June 2016

Sole fixation with the under-absorption rate, however, may mask some challenges related to county revenue management. A county government may have no challenges with absorptive capacity but still be plagued by ineffective procurement and procurement of poor quality goods and services. A consistent under-absorption may also be indicative of poor revenue forecasting and challenges related to budgeting.

Benchmarking the county and community oil revenue allocations against the current budgetary allocations from Treasury may also limit the ability of counties to grow their capacity and demonstrate improved capacity. The current proposed cap for county governments is 20% of government's share of the oil revenue if this does not go above the county's annual allocation from Treasury. What this means is that, if the annual allocations from Treasury do not increase, county governments' share of oil revenue will not go over the current allocations of $10-$11 billion. If county governments do not have increased budgetary allocations from Treasury, they will find it hard to demonstrate improved absorptive capacity. Absorptive capacity can only be assessed based on how much is available to absorb. It will also be important for the county governments to demonstrate, using an evidence base, that they have the capacity to manage oil revenue in-flows.

The discussion on absorptive capacity should also be looked at against poor fiscal probity at national government level. Central government, while raising red flags over county and community revenue absorptive capacity, has itself shown signs of poor macro-economic management. There are concerns over rising debt and difficulties in raising revenues.[18] This is important as discussions around revenue sharing are as much about national fiscal management capabilities as they are about power relations particularly in the context of devolution. It may very well be argued that restricting transfers to counties because absorptive capacity may limit their fiscal autonomy.

CHALLENGES WITH SUB-NATIONAL REVENUE MANAGEMENT

Subnational governments share many of the same challenges of managing natural resource wealth as national governments.[19] Where the national government's fiscal management and probity is questionable, this may have a resultant impact on how revenue is managed at sub-national level. Corruption, opacity and mismanagement of revenue are currently partly characteristic of Kenya's

[18] K. Allen and J. Aglionby, 21 February 2018, Kenya raises $2bn in long-dated debt despite IMF row, the Financial Times, Accessed here https://www.ft.com/content/ae2cd40c-171b-11e8-9e9c-25c814761640
[19] NRGI, 2015, Subnational Revenue Management, Improving Local development through Resource Wealth https://resourcegovernance.org/sites/default/files/documents/nrgi_primer_subnational-revenue-management.pdf

management of public resources at national level. This may result in challenges in terms of effecting transfers to county level and the overall management of oil revenue.

In as much as oil revenues provide windfall revenues at both national and local community level, they may have a destabilising macro-economic effect. This destabilising macro-economic effect is, in part, related to inflationary pressures due to increased money supply and the Dutch disease. One of the main challenges is related to price volatility.[20] This volatility makes it difficult to forecast earnings from oil revenue and consequently make planning difficult. Completing major multi-year development or infrastructural projects becomes difficult. The challenges of oil price volatility may be exacerbated by the extant challenges such as poor planning and budgeting.

Oil price shocks may also have an impact on local county budgets. Where local counties are earmarking oil revenue for spending on social services, the fluctuations in oil prices means it may be harder to forecast oil revenues and the component of the same- that will shore up local county budgets.

Another potential challenge that is related to oil price shocks is one of timely disbursements from national treasury to county government. Article 219 of the constitution states that a county's share of revenue raised by national government shall be transferred to the county without undue delay and without deduction. Despite these constitutional provisions, there is evidence that the government when faced with slow and low revenue collection may delay transfers to county governments, particularly for development expenditure.[21] These delays will negatively impact on county budgeting processes, affect delivery of critical social services and likely lead to conflict between county and national governments.

It is important to note that where there is a huge in-flow of oil revenues to sub-national level, there may be a huge risk of wasteful spending.[22] This risk is certainly heightened where counties do not have well thought out short-mid-term and long term development plans. The result is that the county governments may end up investing significant sums of money into projects that do not necessarily meet the needs of local community members. This has been noted in Peru, where a large proportion of revenue collected from the mining sector-around 60.3% in 2014- is distributed to municipal and regional governments.[23] Earmarking is provided for but it does not seem to have translated to better utilization and positive impacts in the extraction areas.

The 'Dutch disease' is an economic phenomenon where the increased exploitation and reliance on natural resources results in the systematic decline in other economic sectors, specifically agriculture and manufacturing. At the same time, the economy will be geared toward one sector that absorbs all the resources, labour, and attention of policymakers, which eventually reduces investments in other sectors of the economy. These symptoms are even more dangerous in countries with weak and corrupt institutions, non-democratic regimes, and weak financial systems.[24]

The effects of the 'Dutch disease' may be particularly acute in the case of the Turkana county government as oil production will be taking place in the county. The result is that labour may be attracted from other sectors into the oil sector and there may be a complacency on the part of the county government in terms of widening the revenue and tax base.

Beyond the macro-economic challenges, the county government and the local community may be faced with governance related challenges. Section 85 (3) of the Petroleum Exploration, Development and

[20] A. Bauer et al, 2016, Natural Resource Revenue Sharing, NRGI and UNDP http://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/nrgi-undp-natural-resource-revenue-sharing.html pg59

[21] R. Otieno and G. Mosoku, Release County Funds Now, Governors Tell Government, The Standard, 27 February 2018 https://www.standardmedia.co.ke/business/article/2001271266/release-county-cash-governors-demand

[22] A. Bauer, 2013, subnational oil, gas and mineral revenue management https://resourcegovernance.org/sites/default/files/Sub_Oil_Gas_Mgmt_20151125.pdf

[23] M. Aresti, 2016, Revenue Sharing Case Study- Mineral Revenue Sharing in Peru https://resourcegovernance.org/sites/default/files/documents/mineral-revenue-sharing-in-peru_0.pdf

[24] J. Chaaban, J. Hard, 2015, *'Macro-economic implications of windfall oil and gas revenues in Lebanon'* , Lebanese Center for Policy Studies, Policy Paper http://www.lcps-lebanon.org/publications/1450350528-jana_harb-paper_eng.qxp_lcps.pdf

Production Bill provides for the county government to legislate on the establishment of the Board of Trustees and the prudent utilization of the funds received for the benefit of the present and future generations. The law states that the Board of Trustees shall be established in consultation with the local community. However, the process of agreeing on the fiscal rules for the fund and establishing a BoT may be fraught with conflict as different groups within the county seek representation within this important governance body.

An example of the impact of windfall revenues on local government can be exemplified by the case of Ite, a small coastal district in Southern Peru. Tax revenue collected from a local copper mine and transferred from the national to municipal level resulted in the municipal government budget jumping from less than $500,000 to more than $13 million annually.[25] There was, consequently a spending glut on infrastructure such as stadia, schools and other administrative buildings. This resulted in rising construction wages thereby drawing labor from agriculture.

RECOMMENDATIONS TO ADDRESS CHALLENGES RELATED TO SUB-NATIONAL PAYMENTS

The challenges related to determining a widely-accepted revenue sharing formula and managing sub-national payments are not insurmountable. Below are recommendations on how sub-national payments may be effectively managed in Kenya.

Central Government (Treasury, Commission on Revenue Allocation and Auditor General's Office)

- The national government and the legislature should ensure that the revenue sharing formula that is finally codified in law is a product of consultation and consensus building. This is important in mitigating conflict and ensuring the stability of the formula particularly where there is strong political contestation and where there is ethnic diverse diversity across the country.[26]
- To ensure public confidence in the final revenue sharing formula, the Commission on Revenue Allocation should give the rationale behind the formula. This is in line with the full disclosure of the current revenue sharing formula for transfers from National Treasury where factors such as population, poverty, land area, fiscal effort and development are weighted.[27]
- Government should explore options of implementing a flexible cap or a cap on sliding scale. Such a cap would recognize increased and improved absorptive capacity at county and community level; and would ensure that formula is not static.
- The national government should not shy away from implementing revenue sharing formulas that are capacity demanding. The capacity of sub-national governments can be strengthened to ensure that they able to manage oil revenue inflows. This could include seconding staff from Treasury, Economic Planning departments and or the Kenya Revenue Authority to provide support; or this could include mandating that a certain percentage of the annual county budget is spent on capacity building efforts including getting qualified additional personnel and budgeting for training capacity building.

[25] A. Bauer, 2013, Subnational Oil, Gas and Mineral Revenue Management, NRGI Policy Paper https://resourcegovernance.org/sites/default/files/documents/sub_oil_gas_mgmt_20160809.pdf
[26] A. Bauer et al, 2016, Natural Resource Revenue Sharing, NRGI and UNDP http://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/nrgi-undp-natural-resource-revenue-sharing.html
[27] Commission on Revenue Allocation, Revenue Allocation Formula http://www.crakenya.org/information/revenue-allocation-formula/

- National government should support county governments in legislating for extractive revenue sub-national payments management as provided for under Section 85(4) of the Petroleum Bill.
- The national government should invest resources into financial modelling of oil projects and the revenues that may accrue to both national and sub-national government. The input assumptions into this model would be more accurate as government would have better data in terms of terms within the current PSAs; and this may assist in forecasting the revenue receipts at both national and sub-national levels. In addition, it would be worthwhile to institute full contract or PSA disclosure as this would ensure that there is no information asymmetry and that county governments have access to the terms and conditions under which agreements have been made.
- There should be consistent auditing of county government financial statements. This should go beyond analysing aspects related to the split between development and recurrent expenditure; and the levels of absorption. The mandate of the Auditor General is already wide enough and includes physical quality inspections and verifications. A special audit of petroleum revenues could be instituted to ensure there is sufficient confidence in the management of oil revenues at sub-national level.
- The auditor general could consider instituting an audit to assesses the readiness of County governments to receive additional petroleum resources. This could constitute a capacity needs assessments and developing a time-line within which to address that. Some of the systems that could be looked at include; budgeting, project appraisal, public procurement and evaluation procedures.[28]
- Publicise the anticipated 'timing' of disbursements, considering the potential for delays; and ensure strict adherence to those published disbursement timelines.
- Publicly disclose the receipts from petroleum production and the calculation of what is due to the sub-national. This will help build trust between national and sub-national government and will ensure that the general citizenry and community members have the information with which to hold their government accountable. In this regard, adopting and implementing the Extractive Industries Transparency Initiative would be worthwhile.

County Government and County Assembly

- County governments should work with national government to explore the efficacy of establishing sub-national funds with strong fiscal rules at local level. The Bill currently provides for this as it has a provision for the county government to legislate not just on the establishment of a board of trustees; but also, the establishment of laws related to the prudent utilisation of oil revenue. The establishment of national petroleum funds or sovereign wealth funds is already common as there is consideration for the potential negative macro-economic impact oil revenue may have due to potential windfalls and price volatility. Strong fiscal rules would limit what is available for spending and how funds are accessed.

  Establishing a sub-national fund would go some way in addressing the concerns around absorptive capacity. The fiscal rules for sub-national funds can be used to cap what is available to the local county governments while providing them with an inter-generational fund. Anything over and above the cap would still make its way to the sub-national fund with strong fiscal rules to ensure that the funds are inaccessible for that financial year. Establishing a sub-national fund could help counties to build a reserve to cushion the highs and lows oil price volatility.

  Alternatively, counties should propose that sub-national funds for county and community allocations be established at central level. These funds would receive the full annual percentage allocation without the cap. Contingent on demonstrable absorptive capacity, the county and community levels would receive a portion of this allocation from the fund with the rest being solely held in trust by central government on their behalf for tapping into once oil production ceases.

[28] A. Bauer, 2013, Subnational Oil, Gas and Mineral Revenue Management, NRGI Policy Paper https://resourcegovernance.org/sites/default/files/documents/sub_oil_gas_mgmt_20160809.pdf

- Leverage oil revenue sub-national transfers to diversify the economic or tax base of counties. In this regard, a certain percentage of the oil transfers could be earmarked for investment and diversification into other economic sectors such as agriculture, tourism and or manufacturing.
- To improve spending outcomes, that is, the benefits experienced by the community, county governments should create detailed, costed and comprehensive development plans. These multi-year plans can help governments transition toward a diversified economy and overcome development bottlenecks. Development planning is also an opportunity to align subnational government spending with spending by other actors, such as extractive companies and the national government.
- County governments should ensure that legislating on the prudent utilization of petroleum funds includes requiring earmarking of resource revenue transfers to specific line items related to health, education or other social infrastructure, thus limiting subnational government discretion in planning how such revenues might be spent.[29]
- Provide sufficient autonomy to the community BoT but retain mandate to provide support and oversight in terms of ensuring revenue transparency and accountability over the management of petroleum revenues.
- There should be improved transparency and accountability on sub-national revenue receipts and the spending thereof. This is particularly important as additional revenue inflows may result in corruption. Transparency and accountability would help address procurement related corruption and possible cases where funds may be potentially siphoned off to companies beneficially owned by members of BoT. Transparency not only provides a basis for accountability but will also assist in mitigating conflict.
- Pre-disbursement, the county government should play an active role in validating the oil revenue receipts and the amount due to the county.
- The national and county government should make significant investments in building and strengthening governance and financial management systems at both county and community levels.

[29] A. Bauer et al, 2016, Natural Resource Revenue Sharing, NRGI and UNDP http://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/nrgi-undp-natural-resource-revenue-sharing.html pg 62

Notes

This paper uses revenue forecasting data from research commissioned by the Kenya Civil Society Platform on Oil and Gas (KCSPOG). The 2016 research report, titled 'Potential Government Revenues from Turkana Oil, uses various base case assumptions to come up with an economic model for Blocks 13T and 10BB.[30] *It notes that the results from economic modelling are not predictions of actual government revenue, particularly for projects not yet in the development stage. Rather, they provide estimates of potential government revenue under specific sets of assumptions related to production volumes, oil price and field costs. The analysis was based on the following base case assumptions:*

- 600 million barrels of recoverable oil;
- First oil production in 2021, production life of 20+ years;
- First phase peaks at 75,000 bopd; second phase peaks at 150,000 bopd;
- Brent crude oil price - $45 low, $65 medium and $85 high (with $8 discount for quality);
- Costs are: exploration ($1.8b), development ($6/bbl), operating (6% of development); pipeline tariff ($10.70);
- Production sharing terms from Block 10A; and,
- State participation for 10BB (20%) and 13T (22.5%).

While the report was developed in 2016, there is little need to change the base case assumptions. On recoverable oil, the research worked with a 2C estimate of 600million barrels. In its 2017 Full Year results, Tullow notes[31] *that following a full assessment of all the exploration and appraisal data, Tullow estimates that the South Lokichar basin contains recoverable resources as follows- 240 – 560 – 1,230 mmbo (1C–2C–3C). This paper maintains the 2C estimate of 600mmbo as the updated estimate is 560mmbo which is just under 600mmbo.*

Another change is with respect to the Final Investment Decision (FID) which in the KCSPOG paper was estimated (based on publicly available data then) for 2017. Tullow, in its 2017 full year results- now puts FID in 2019. The FID affects when First Oil is expected and the production projections from ramp up, plateau to the taper off. Changes in the FID, however, do not necessarily change the revenue projections based on the base case assumptions.

[30] KCSPOG, 2016, Potential Government Revenues from Turkana Oil, discussion Paper, http://kcspog.org/wp-content/uploads/2016/04/Revenues-from-Turkana-Oil-April-2016.pdf pg17

[31] Tullow Oil 2017 Full Year Results https://www.tullowoil.com/Media/docs/default-source/3_investors/2017-full-year-results/tullow-oil-plc---2017-full-year-results-statement-final-updated-2.pdf?sfvrsn=12 pg 5