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Commentary Today

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It is time to embrace a free market of petroleum as price control fails

Michael Owuor



Cabinet Secretary for Energy Amb. Monica Juma leading government response in addressing the petroleum shortage crisis.

The long lines at gas stations experienced at the start of April 2022 reignited conversations on the marketing of petroleum. It has brought to the fore the role of government price control in a free market economy. To understand the dilemma facing policymakers, it is important to document how the country arrived at this conundrum.

The price of petroleum has surged since the reopening of global economies from the scourge of the COVID-19 pandemic. The Free on Board (FOB) price of Murban crude oil increased to \$112.28 per barrel in May 2022 from \$93.33 in April 2022. Oil price forecasts for the remainder of 2022 remain uncertain. The incremental price of oil in the local market is exacerbated by the Russian invasion of Ukraine and the steady depreciation of the Kenyan shilling. As an importer of petroleum products, these dynamics are beyond the control of any single actor, including the government.

Due to the impact of rising oil prices on the economy, the government initiated the Petroleum Development Levy Fund. Designed as

a stabilization fund, the Levy collected KES 5.40 from the sale of each liter of petrol and diesel, and KES 0.40 from a liter of kerosene. This collection would be employed to compensate Oil Marketing Companies (OMCs) when oil prices surpassed a threshold set by the Energy and Petroleum Regulatory Authority (EPRA). However, with the unforeseen surge in prices, the Levy was unable to accomplish the set role. Two reasons have been advanced to explain this.

First, the Levy had low funds to stabilize oil prices. Parliament, in September 2021, learned that KES 18.1 billion from the Levy was used to defray operation costs related to the standard gauge railway and fund energy as well as infrastructural projects. Secondly, the global oil prices rose so rapidly that the Levy could not sustain itself. Thus, the Levy transitioned into a fuel subsidy program with direct funding by the government. However, in April 2022, the Cabinet Secretary for Treasury underscored that government support for fuel subsidy would



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require KES 10 to 15 billion, monthly. This is hardly a viable trade-off. In the financial year ending July 2021, the levy raised KES 26.1 billion after increasing the rates in July 2020. This is unsustainable for a government burdened with significant fiscal deficits.

As a result, the government's decision to control fuel prices has been questioned. Proponents of price control, including the government, argue that it aids in mitigating inflationary pressures. Thus, the ripple effects from rising oil prices are rarely transferred to the end products and services. The fuel savings result in stable production costs.



Photo Credit: Business Daily

EPRA's Director General appears before Parliament to respond to questions about the rise in fuel prices

However, it is imperative to note that everything has a cost. The government's fuel subsidies, no matter how noble, are at the cost of other important social services. Every shilling spent subsidizing petroleum prices means less for health, devolution, education, and other services. These have ripple effects too. Equally, anecdotal reports indicate that the OMCs in Kenya have experienced strained cash flows due to the perennial delays by the government to remit subsidy funds. Thus, the OMCs remain reluctant to sell to the local market, at loss-making rates. With restricted cash flows, subsidy programs force the government to explore other revenue-raising measures including debt. Among them is the government's intention to raise around one billion dollars in June 2022 through the Eurobond facility. This is intended to finance the 2021/2022 budget. But with a rising global interest rate of between 6 to 12%, such measures are too expensive.

While the Ministry of Energy insists on petroleum price control, this has left the marketplace in a fix. Experts opine that the imposition of controls to keep prices below their real levels has four troubling ramifications. They are; increased use of the product due to fear of stockouts; reduced product supply due to hoarding; and deterioration of quality due to unscrupulous dealers. The other effect is that black markets become prevalent as actors take advantage of unstable demand and supply dynamics. All these scenarios were witnessed in April 2022 during the fuel shortage crisis.

With anticipated challenges in the government's funding of the subsidy program, the OMCs will shun to supply to the local market. Evidence indicates that OMCs prefer to sell to profitable regional markets, hence the continued export of 80% of their products to Uganda, the Democratic Republic of Congo, and Rwanda, despite a government directive to curtail the practice. It is imperative to note that these countries have no price control on petroleum. Efforts by EPRA to curtail hoarding on account of economic sabotage are founded on precarious legal grounds. Article 40 of the Constitution of Kenya 2010 guarantees property rights. Thus, Parliament should be dissuaded from enacting a law that curtails this enjoyment. Compelling OMCs to sell their wares at a loss limits this enjoyment. There are propositions to award the National Oil Corporation (NOCK) exclusive rights to import 30% of the country's fuel. This is intended to



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safeguard local supply lines. However, it is challenging to secure supplies at lower rates than those paid for by OMCs. This means that tax funds will continue to foot a significant part of the national fuel expenditure. NOCK is equally predisposed to management inefficiencies experienced in other state-owned entities like the Kenya Power and Lighting Company (KPLC).

Policymakers have to appreciate the consequences of price control. The loss of productivity and working hours utilized to queue for fuel are detrimental to the economy. Equally, the fuel subsidy program is unsustainable. With the fundamentals in the global petroleum market anticipated to hold to the end of the year, fuel subsidies would gobble between KES 80 billion to KES 120 billion. The government should follow the precedence of her East African neighbors who have allowed for the free marketing of petroleum. Oil prices in East African states are similar to projected non-subsided Kenyan prices of KES 184.68 for a liter of petrol, KES 188.19 for a liter of diesel, and KES 170.37 for a liter of kerosene. Even with these measures, most of these countries have lower or similar inflation rates than Kenya. Thus, subsidizing these products at KES 25.56, KES 48.19, and KES 42.43 per liter respectively are unmatched and injurious to the country's energy security.

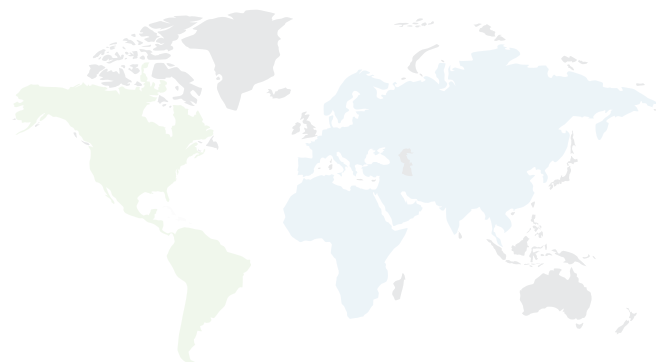


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In conclusion, it is economically imprudent to highly tax petroleum products only to heavily subsidize them at the same time. The Ministry of Energy and Petroleum thus faces two choices: either allow for higher unregulated prices with assured availability and quality or continue with subsidized prices amidst dwindling supplies. A better compromise would be to remove price controls, eliminate the Petroleum Development Levy Fund, and the 8% value-added tax on petroleum products.



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