

# THE EAST AFRICAN ENERGY FRONTIER, A DECADE ON

ASHLEIGH HAYMAN

## EXECUTIVE SUMMARY

The East Africa region has seen some of the decade's largest natural gas and energy finds. However, despite their magnitude, these discoveries have yet to fulfil the promise of social and economic progress. With some signs of the negative impact of resource wealth already in evidence, Uganda, Kenya, Tanzania and Mozambique all require changes to their natural resources policies to ensure that revenues are shared and invested in the future. Underpinning this is the need for governments to improve transparency, allowing local institutions to hold the government and other stakeholders accountable. Without such steps, the full potential of these finds is set to go unrealised.

## INTRODUCTION

A full decade has passed since Uganda first found substantial energy deposits in Eastern Africa, drawing the eyes of investors to the region and earning it its description as the new focal point for hydrocarbon exploration. The oil discoveries in Uganda, near its border with the Democratic Republic of Congo (DRC), were the largest in sub-Saharan Africa in over 20 years and are estimated at 6.5 billion barrels.<sup>1</sup> It is not surprising that it attracted major energy players such as France's Total E&P, China's CNOOC and the Anglo-Irish Tullow Oil, which now hold most of the drilling licences. Kenya has significantly less oil,

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although recent finds bring it up to a possible 750 million barrels. Meanwhile, as the natural gas sector in developed countries petered out, global energy companies looked to Mozambique, which confirmed vast gas deposits in 2011. The country now has an estimated 100 trillion cubic feet of proven reserves, making it one of the century's largest discoveries and positioning Mozambique as the country with the third-largest natural gas reserves in Africa.<sup>2</sup> Neighbouring Tanzania has also attracted attention, with recent finds bringing its recoverable reserves to more than 57 trillion cubic feet.

However, the translation of these finds into successful production, as well as economic and social benefits, is far from unhindered. Neither Uganda nor Kenya has started commercial production, with the former witnessing a series of regulatory and tax disputes between the government and international oil companies. The country's first oil exports are now not expected until 2020 at the earliest.<sup>3</sup> Such issues are not confined to Uganda, with hurdles including a trilateral dispute concerning pipelines, universal issues over transparency and management, and concerns over energy prices, security, finance and political stability. A decade after the first major energy reserves were discovered in the region, this paper assesses the progress made in the development of the region's oil and gas sector, including aspects of governance and accountability.

## **OIL: DISPUTES OVER PIPELINES, REFINERY**

In order to export internationally, landlocked Uganda requires a coastline destination for its planned crude oil pipeline, which will be the first of its kind in the region. In August 2015 the presidents of Uganda and Kenya agreed to jointly develop such a pipeline along the 'northern route' via Kabaale and Lokichar to a new port development in Lamu, on Kenya's north-eastern coast. While this was canvassed as a move towards greater Eastern African integration, it was not long before these plans ran into difficulties. By late October 2015 Uganda had signed an agreement with Tanzania to explore the possibility of an alternative route to the deepwater port at Tanga. A Ugandan technocratic report found that the 'Kabaale–Tanga route is the only option to secure first oil export by mid-2020, with pipeline availability of 99 per cent'.<sup>4</sup> In contrast, the Kabaale–Lamu route was expected to be operational only in mid-2022. The choice of the Tanzanian route was officially announced at a summit of the East African Community in April 2016 and construction was planned to start by August 2016.

While this may have come as a nasty surprise for the Kenyan government, there were a number of reasons for the decision. Total is widely believed to favour the Tanzanian route due to both cost and security. While Tullow favoured the Kenyan route on the basis of its own interests in the area, Total expressed concerns that the route would pass close to the Somali border, where al-Shabaab Islamists have carried out attacks. Ugandan Foreign Affairs Minister Sam Kutesa also highlighted the cost factor. The Tanzanian president claims that Total has set aside \$4 billion to contribute directly to the pipeline, matching the projected cost of the Tanzanian route, which is up to \$1 billion less than the projected route through Kenya. Furthermore, Kenya's proposed tariff was almost \$17 per barrel, compared to Tanzania's \$12 per barrel.<sup>5</sup> Uganda's energy minister also reported that Tanzania waived land fees and taxes associated with the pipeline, although

there have been queries around the viability of such exemptions in the long term. Furthermore, the Tanzanian port of Tanga is already fully operational, while the development of Kenya's Lamu port is two years behind schedule.<sup>6</sup> There have also been environmental and financial concerns around the dredging of the Kenyan port, creating further risk of delay.<sup>7</sup>

In addition to the issues outlined above, there have been concerns over the complex politics involved in displacing people and acquiring land, as well as over the pipeline's impact on Kenya's national parks. There are fears that a pipeline through Kenya would endanger ecologically sensitive ecosystems – it is reported that the Kenyan route would cross 167km of protected wildlife areas, while the Tanzanian route would not infringe on any such protected zones.<sup>8</sup> Furthermore, the aforementioned report found that Kenya had spent on average over two years settling compensation for acquired land, while Tanzania took on average only nine months. This may in part be due to the fact that the Tanzanian state legally owns the country's land, and compensation levels are prescribed by law. However, this is not to say that acquisition there is without challenges; a lengthy deadlock over land for a liquefied natural gas (LNG) plant near Dar es Salaam was only resolved in January 2016.<sup>9</sup> The issue of potential land disputes is a pivotal factor to a country such as Uganda, which has already witnessed increased unrest over apparent 'land grabbing' in oil-rich areas and a failure to provide adequate resources and support for resettlement.<sup>10</sup>

Regardless of the reasoning, oil firms in both countries will be relieved that a decision has been made. Tullow had warned that final investment decisions in Uganda and Kenya could not be made until at least 18 months after a route has been selected.<sup>11</sup> The execution of the project is expected to create 15 000 jobs in the two countries,<sup>12</sup> although residents have voiced concerns that jobs may primarily go to foreigners. Uganda has also long expressed the desire to develop a local oil refinery plant – plans that have largely been opposed by oil companies, which argue that with such comparatively small economies of scale such a project provides no competitive edge. These disagreements were resolved in 2014 with the affected parties signing a Memorandum of Understanding, which included plans for both an export pipeline and an oil refinery, although one operating on a smaller scale than initially suggested by President Yoweri Museveni. Construction is estimated at \$2.5 billion, and a projected 60 000 barrels per day will be processed when production begins in 2018. Although most crude oil will still be exported, the local processing of a share of production is meant to cater for the demand for refined petroleum products in the region. Tanzania has agreed to take an 8% stake in the refinery, which, compared to Kenya's proposed 2.5% share, may have been an extra incentive in the choice of route.<sup>13</sup>

This was not the only issue to arise between the Ugandan government and the involved oil companies, which have also been at odds over capital gains tax and lengthy delays in the issuance of production licences. The capital gains tax disputes centred on both Heritage Oil's sale of its stakes in Ugandan oil blocks to Tullow in 2010 and Tullow's later farm-downs to Total and CNOOC in 2012. Tullow Oil initially paid the majority of Heritage's tax liabilities for the 2010 sale, as the Ugandan authorities refused to recognise the sale until these were fulfilled, though Tullow was later awarded \$340 million in compensation.<sup>14</sup> Tullow also reached an agreement with the Uganda Revenue Authority in 2015 over its own sales to Total and CNOOC, agreeing to pay \$250 million in settlement.<sup>15</sup>

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The rerouting of the proposed pipeline also has political ramifications for Kenya's \$25 billion Lamu Port–South Sudan–Ethiopia Transport Corridor (LAPSSET) development, which already faces objections from local communities

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Meanwhile, Kenya has said it will build its own pipeline from Lokichar to Lamu, to be completed by 2021, and claims that the International Monetary Fund (IMF) and the African Development Bank have shown interest in providing funding.<sup>16</sup> However, Kenya 'will get less per barrel if it builds its own pipeline', according to a senior economist at NKC African Economists.<sup>17</sup> It will now be significantly more difficult for Kenya to attract funding for this project, projected to cost \$2.1 billion.<sup>18</sup> The rerouting of the proposed pipeline also has political ramifications for Kenya's \$25 billion Lamu Port–South Sudan–Ethiopia Transport Corridor (LAPSSET) development, which already faces objections from local communities.

It had been hoped that the Kabaale–Lokichar–Lamu route would provide a link for South Sudan's oil. South Sudan has been in a dispute with Sudan over the fees to use its pipelines to export oil. However, Ethiopia recently secured a deal to develop a pipeline with Djibouti, providing an alternative route for South Sudan's oil. This may mean that Kenya's partners in the LAPSSET project may be dwindling. These issues give credence to the Kenyan Parliamentary Budget Office's concerns that Kenya's poor economic policies have eroded the confidence of other East African countries to participate in joint projects.<sup>19</sup> However, in June 2016 Ethiopia alleviated some of these fears by signing an agreement with Kenya to construct a crude oil pipeline running from Lamu to Addis Ababa. There have also been other positive developments, as Kenya's government intends to start transporting crude oil to the port city of Mombasa using trucks and rail, and the first crude oil for testing may be produced as early as mid-2017.<sup>20</sup> Mount Kenya University has signed a deal with the China University of Petroleum to help build capacity for the skills needed in the sector. Disputes between the majority party and the marginalised counties from where most of the oil has been sourced may be resolved with the Petroleum Bill of 2015. The bill intends to grant 25% of the state's share of profits to county governments and local communities,<sup>21</sup> and to help prioritise the employment of Kenyan workers in the sector.

Ugandan oil finds are predominantly located in the region of Lake Albert on the border with the DRC, which continues to suffer from resource-driven conflict. Both governments dispute the demarcation of the border in this area and clashes have only been exacerbated by the oil finds. Armies were deployed by both sides around Lake Albert following the discovery, and fighting erupted during the second half of 2007. The respective presidents have since signed the Ngurdoto Agreement promising co-operation over the oil discoveries. The Ugandan Minister for Foreign Affairs, Henry Oryem Okello, stated in 2012 that the country would be taking a neutral stance in order to avoid conflict 'spoiling' joint development.<sup>22</sup> However, disputes in the area are ongoing, with four Ugandan police officers killed in May 2016<sup>23</sup> and Congolese officials reportedly withdrawing from the agreement's proposed boundary commission.<sup>24</sup> While the cross-border joint development of the Lake Albert region could reduce costs on both sides, such hopes are likely to be left unrealised as the countries continue to face conflicts at their border.

## NATURAL GAS: INFRASTRUCTURE, POLITICS AND DEBT

Eastern Africa's 11% year-on-year increase in foreign direct investment in 2015 correlates with the potential of the significant offshore gas discoveries made in Tanzania in recent years.<sup>25</sup> In line with this Tanzania has begun to develop its

own energy infrastructure, which includes plans to build a pipeline to supply natural gas to Uganda. This will serve to further cement commercial ties between the two countries, laying the foundation for Tanzania to become the region's energy hub. This is not the first gas pipeline constructed in Tanzania, with another recent addition spanning 532km to bring new supplies to the commercial capital Dar es Salaam. Tanzania has also commissioned an LNG processing plant in the southern region of Lindi, financed by a \$1.2 billion Chinese loan.<sup>26</sup> These projects, if successfully implemented, could provide long-term benefits in the form of an estimated \$5 billion in annual LNG exports by 2025, a reduction in energy imports, tax revenue, gross domestic product (GDP) growth and job creation.

However, there have been concerns that such prospects could be significantly affected by the dramatic and prolonged downturn in LNG prices. Notwithstanding a slight increase in recent months, there has been a reported 75% decrease in LNG prices over the last two years.<sup>27</sup> This pricing uncertainty has been linked to the drop in crude oil prices, but, despite oil prices' having risen in the first half of 2016, LNG prices have continued to drop. In addition to this is the potential of future oversupply in the LNG market, which may suppress prices in the medium term. With competition due to come from both Australia and the US, the window of opportunity seems to be narrowing.

Against this gas price backdrop, the development of further gas projects in Mozambique is already facing financial challenges and ever-retreating production dates. Furthermore, with a rapid increase in debt-to-GDP ratios since 2008, questions have begun to arise on whether the country has already squandered expected profits. The Mozambican government's announcement in May 2016 that it had been concealing debt estimated at \$1.482 billion raised the possibility of a sovereign default, with the country being downgraded by credit rating agencies. Compounding this is a swiftly depreciating currency, a downturn in investment and no binding agreements with LNG buyers, meaning that Mozambique's projects are struggling to source final investment decisions, which are now not expected until the end of 2016.<sup>28</sup> This has worsened conflict with the former rebel group Renamo (Resistência Nacional Moçambicana) and sparked the threat of a repeat of the 2010 riots. The start date for production has been pushed to 2019, with exports expected in 2021, and questions are being raised as to how Mozambique will meet its debt repayment commitments. The Group of 14 budget-support donors have suspended their contributions and SacOil Holding Ltd. has held off on signing a joint venture agreement to build the \$6 billion 'African Renaissance' pipeline to South Africa's Gauteng, stating it needs to do further assessments.<sup>29</sup> The IMF visited Mozambique in June 2016 and highlighted that 'effective implementation of both the corrective macroeconomic measures and the measures aimed at strengthening transparency, improving governance, and ensuring accountability' was needed before such funding could resume.<sup>30</sup>

However, Sasol, which has been producing gas from Mozambique's Temane and Pande gas fields since 2004, almost doubled its sales of Mozambican natural gas in the nine months to March 2016 compared with the same period in the previous year, up to 12.4 billion cubic feet.<sup>31</sup> This is in part thanks to the \$250 million Ressano Garcia Power Plant, unveiled in 2014, with the company planning to increase the capacity of its processing facility in Temane as regional demand grows. While Anadarko and Eni seem to be slowing down efforts, Sasol announced

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in May 2016 that developments under its \$1.4 billion gas project would not be affected by the debt crisis.<sup>32</sup> Mozambique will still need to reach past such regional demand to the Asian markets to maximise the potential of its gas sector. However, with government approval of Eni's Coral FLNG project and the awarding of six new licences for oil and gas exploration in October 2015, there has been some positive momentum. Such developments could boost the size of the economy ninefold by 2035.<sup>33</sup> In the short term, however, with the resource curse threatening, Mozambique is in dire need of significant cuts to its expenditure, repayment negotiations and a more accountable and united government to lead the way out of present difficulties. There are signs that this message is being heard in Maputo, with a planned 10% cut to public expenditure this year and President Filipe Nyusi's formally expressing his support for talks with Renamo.

## EITI, TRANSPARENCY AND THE RESOURCE CURSE

A key antidote to the so-called 'resource curse' is a strong commitment to transparency and accountability. In line with this, many believe that the international standard set by the Extractive Industries Transparency Initiative (EITI) effectively reduces the risk of corruption and mismanagement by empowering outside actors to enforce accountability over revenue. This in turn creates a more attractive investment environment.<sup>34</sup> Uganda expressed its intention to join the EITI in its 2008 National Oil and Gas Revenue Management Policy. Despite repeated public commitments this has yet to transpire and the Ugandan Parliament has objected to the presidential and ministerial stranglehold on the oil industry, calling for greater oversight. Donors have provided support to improve energy sector governance in the region, with the Norwegian government committing \$6.5 million in 2015 to strengthen the management of Uganda's oil and gas sector and actively encouraging Uganda to subscribe to such established mechanisms as the EITI. Kenya is also not a member of the EITI, despite commitments to the US in 2015.<sup>35</sup> However, Article 71 of its constitution requires parliamentary ratification of the granting of extraction rights, which may be further solidified by the proposed Natural Resources Bill of 2015.

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Tanzania has been declared EITI-compliant, and enshrined the standard into its legislation with the EITI Act of 2015, but reportedly an assessment of how Tanzania awarded gas exploration contracts between 2010 and 2014 revealed serious flaws.<sup>36</sup> Mozambique, which is also said to be EITI-compliant, is facing very real concerns over corruption, bad debts and liquidity, and has seemingly fallen prey to the resource curse before exports have even materialised. There is also concern over the way exploration licences were agreed on and tax exemptions given when the country was still classified as high risk. This adds credence to arguments that the EITI remit is not broad enough and falls short if the reviews do not lead to broader government reforms and effective prioritisation within national institutions. Others perceive the standard as being based on Western agendas geared more towards developed countries (some of which have not yet fully implemented the standard, such as Australia and the UK).<sup>37</sup> Kenya, Uganda, Tanzania, Mozambique, Sudan, Ethiopia and Angola have all called for the formation of an African transparency organ that reflects a home-grown response to the need for improved governance of the extractives sector. These calls have resulted in emerging work on the African Extractive Industry Governance Framework (AEIGF).<sup>38</sup>

The AEIGF, although potentially more acceptable to African states, is likely to face many of the same challenges as other accountability frameworks: they cannot be effective without supporting legislation at the national level, nor can they become effective tools for accountability if parliaments, the media and civil society do not have the necessary freedom to engage government on issues raised by these frameworks. Freedom House rates Uganda, Kenya, Tanzania and Mozambique as only 'partly free',<sup>39</sup> indicating that such freedoms are not yet sufficiently guaranteed. Uganda and Kenya received the worst ratings, with Human Rights Watch reporting in January 2016 that vaguely worded legislation in Uganda provides opportunities to suppress journalists and civil society,<sup>40</sup> while the majority leader of the Kenyan National Assembly publicly accused non-governmental organisations of trying to undermine and destabilise the government in November 2015.<sup>41</sup> Whether transparency comes from a more localised source or internationally, it needs to be supported and implemented at a domestic level and foster co-operation among governments, energy companies and local agents.

## CONCLUSION

The past decade's energy finds created great promise for Eastern Africa. Yet questions remain about whether these finds will be a burden or blessing. With the downturn in global energy markets and production dates being repeatedly postponed, any potential benefits are subject to the uncertainties and political volatilities that have come to characterise the region. However, it is not too late for these countries to use their assets wisely. A real commitment to accountability and the channelling of revenues towards development objectives is needed, as well as the necessary freedoms for local institutions to monitor the sector and hold government and other stakeholders to account. Now, while prices are low, is a good opportunity for states to get their institutional houses in order. With the effective infrastructure in place, as well as co-operation between states and profits being invested in their future, these finds can in time contribute to the development of the region.

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