A NEW FRONTIER: OIL AND GAS IN EAST AFRICA
# Table of Contents

## A New Frontier: Oil and Gas in East Africa
- Introduction .................................................. 1
- Engaging with government .......................... 2
- Vested interests ........................................... 2
- Corrupting influence .................................. 4
- Building for the future ............................... 5
- Community relations ................................. 6
- Conclusion .................................................. 8

## Country Snapshots
- Kenya ....................................................... 10
- Tanzania .................................................... 10
- Ethiopia ...................................................... 11
- Uganda ......................................................... 11
- Mozambique ............................................... 12

## East Africa Country Risk Ratings 2012 .......... 13
EAST AFRICA OIL AND GAS BASINS

- **UGANDA**: Kampala, Hoima
- **KENYA**: Nairobi, Mombasa, Lamu
- **TANZANIA**: Dodoma, Dar es Salaam, Songo Songo, Mombasa
- **MOZAMBIQUE**: Nacala, Nacala

**Basins**:
- **OGADEN BASIN**
- **RIFT VALLEY BASIN**
- **RUVU BASIN**
- **ROVUMA BASIN**
- **LAMU BASIN**
- **SOUTHERN RIFT BASIN**
- **ALBERTINE BASIN**

**Ports**:
- Addis Ababa
- Kampala
- Hoima
- Nairobi
- Lamu
- Dar es Salaam
- Mombasa
- Nacala
A NEW FRONTIER: OIL AND GAS IN EAST AFRICA

INTRODUCTION

After decades operating in the shadow of North and West Africa, East Africa is finally emerging as one of the most significant players in the continent’s oil and gas industry. Large oil discoveries around Uganda’s Lake Albert in 2006 and subsequent gas discoveries offshore Mozambique have dramatically altered perceptions of East Africa, transforming it into an up-and-coming destination for extractive industry investment. Companies that previously only gave the region a passing glance before turning their attention to areas such as the Gulf of Guinea are now rapidly coming to terms with the Rift Valley’s potentially vast, untapped reserves.

Exploration has been underway in East Africa for several decades, but the extent of the potential has only become apparent in the last few years. Uganda looks set to become one of the five largest oil producers on the continent, with its Lake Albert oil fields potentially capable of producing 200,000-350,000 barrels per day (bpd). News of fresh discoveries in neighbouring Kenya has boosted onshore exploration in that country, though commercial viability is still being established. South Sudan already has vast reserves and is increasingly looking to East Africa rather than to its hostile northern neighbour to export its oil. Meanwhile, there are hopes that both oil and gas could be discovered in Ethiopia in commercially viable quantities.

Offshore, the picture is even more promising. The waters of the Indian Ocean are proving a rich hunting ground for natural-gas exploration. The US Geological Survey estimates that coastal areas of Mozambique and Tanzania alone could harbour more than 250 trillion cubic feet of gas in addition to a further 14.5bn barrels of oil. The success rate of companies looking for gas offshore is phenomenal: of the 27 wells drilled in the last two years offshore Tanzania and Mozambique, 24 have yielded discoveries. Compared with the heavily explored areas elsewhere on the continent, East Africa is practically virgin territory; by 2010, only 600 wells had been drilled, compared with 14,000 and 20,000 in West and North Africa respectively.

Exploration activity in East Africa is no longer solely the domain of oil and gas juniors. As the size and scope of the region’s reserves have become more apparent, so the interest of industry heavyweights has increased. Governments are anxious to attract the attention of international oil companies in addition to the steady flow of interest from juniors. The development of the sector does not only offer opportunities for
upstream investors, and there is increasing focus on vital supporting infrastructure, including pipelines, refineries, port facilities and transport links.

East Africa has enormous potential as a market for oil and gas investment. However, it remains a frontier market, and challenges will arise throughout the course of the investment cycle. Without the decades of operational experience enjoyed by their West and North African counterparts, the region’s governments and bureaucracies have to learn the nuances of the industry quickly. In addition to poor infrastructure, companies have to contend with archaic or non-existent regulations, and a number of competing vested political interests. Local communities are often caught somewhere between euphoria at the prospect of new-found oil wealth and fears for their future land rights.

With the exception of South Sudan, production has yet to begin in earnest anywhere in the region (in many cases important discoveries are still being made), but there are already lessons to be learned. Although Uganda’s oil reserves were enthusiastically unveiled in 2006, the ensuing years have been turbulent, with lengthy negotiations and delays to the production schedule. Investors looking at the steady flow of new discoveries in Mozambique, Tanzania and Kenya should take stock of the Ugandan situation. While each country enjoys its own unique dynamics, there are a number of overlapping issues. Drawing on research and interviews conducted in the region over the last six months, this paper addresses those areas that should be of greatest concern to foreign investors in East Africa, including high-level engagement between companies and government; vested political interests; corruption; lack of infrastructure and cross-regional co-operation; and fragile community relations. It offers insights into navigating a complex, but potentially highly rewarding operating environment.

**ENGAGING WITH GOVERNMENT**

Engagement with regional governments is one of the main challenges facing investors in the East African oil and gas sector. As the industry develops and companies seek to move from exploration to production, relations with host governments have come under increasing strain. Suspicion and, in some cases, barely disguised hostility have characterised the attitude of many officials in the Ugandan and Tanzanian governments towards companies. This wariness during contract negotiations stems from recognition on the part of governments of their inexperience in the sector. Several governments have dispatched official delegations on fact-finding missions to established oil- and gas-producing states such as Norway, where they can glean fresh insights. However, such superficial efforts cannot substitute for the decades of collective industry experience they face on the other side of the negotiating table.

Even where model agreements provide a rigid structure, companies continue to encounter underlying resistance and pressure from governments and NGOs. Contracts come under scrutiny from NGOs and civil-society groups anxious to keep track of where revenues are going. This in turn reinforces the defensive stance of officials who are desperate to avoid appearing weak or ill-informed. The overall effect is to create a trust barrier between companies and host governments that is proving hard to breach.

This barrier tends to be much stronger in countries where commercially viable deposits are already known to exist. While the Kenyan government is anxious to attract further exploration by granting companies the freedom they need, in Uganda the move from exploration to production has been acrimonious. A bitter dispute between companies and the government over tax liabilities has frustrated attempts to start oil production at Lake Albert. In Tanzania, the legacy of the former socialist government can still be felt. Although the government publicly embraces free-market ethos. The government keeps its cards close to its chest when interacting with companies, and mutual suspicion persists.

A cultural shift is needed on the part of government officials in the region to recognise the importance of transparent and positive engagement with companies, not just when awarding exploration licences, but through the entire industry cycle to include the mid- and downstream production chain. All too often there is a chasm between the few ministerial technocrats who understand the nuances of negotiations with oil and gas companies, and their political masters and senior civil servants. Moreover, expertise at a ministerial level tends to wane rapidly as countries move from exploration to production. Where there is existing expertise it tends to be in geology rather than other technical or commercial areas that become more significant once initial discoveries have been made.

These knowledge gaps are unlikely to be bridged in the short term. As a result, companies need to try to make a positive impression at the highest level from the outset. They should communicate a clear in-country investment strategy to senior government officials at the first available opportunity. This should emphasise any initiatives to create linkages to the local economy, such as the employment of local nationals or support for infrastructure projects.

**VESTED INTERESTS**

The high stakes of the oil and gas industry mean that it is not surprising that companies frequently have to contend with political interference. The experience of Uganda offers stark lessons for the rest of East Africa. President Yoweri Museveni has assumed almost complete personal control over Uganda’s oil sector, using his executive muscle to bypass formal structures.

**Ugandan President Yoweri Museveni**
The result is a highly opaque industry, where decisions are made at the whim of the presidency and his inner circle. Initial production-sharing agreements were personally negotiated by Museveni, who has largely disregarded recent efforts by some lawmakers to introduce greater parliamentary scrutiny over contracts. Long-awaited draft legislation still affords the minister (appointed by the president) unchecked power to both issue oil licences and regulate the industry.

The lack of independent oversight is worrying, and Museveni shows little sign of relinquishing his autocratic grip on the oil sector. Such is the level of his personal interest that he appears increasingly likely to run for another term rather than stand down before 2016, which would mark the 30th year of his presidency. The fact that the oil from Lake Albert is scheduled to start flowing a year later will only strengthen his resolve to remain in power; as one activist put it to Control Risks, “Who wants to leave the party just when the food is being served?”

Museveni’s tight personal control over Uganda’s petroleum sector is unparalleled in East Africa. The Ugandan president is in many ways representative of an older generation of politicians who refuse to accept genuine accountability to democratic institutions. Kenyan President Mwai Kibaki will step down next year, and with term limits now constitutionally enshrined across the region, other leaders are unlikely to be able to follow in Museveni’s footsteps. Nonetheless, companies should monitor whether there is adequate development of strong democratic institutions that can check the influence of executive power when it comes to determining oil and gas policy and managing relations with companies. Museveni’s personal intransigence has put back the development of the Uganda petroleum sector by months or even years, and it is important for investors that those dynamics remain an exception rather than the rule in East Africa.

The governments of Tanzania and Mozambique (and potentially soon Kenya), which are moving towards full-scale petroleum production following commercially viable discoveries, are watching Uganda carefully. However, they are likely to find that the problems encountered in Uganda are reflected to varying extents at home.

**LEADING THE WAY**

The role of heads of state is often critical in shaping the investment climate around the extractive industries. In Uganda under Museveni, it has been probably the single most important influence on the development of the oil and gas sector. Museveni has been in power since 1986 and, despite already serving his fourth term, looks like he may contest a fifth term in 2016. The trend elsewhere in the region is more encouraging. The presidents of Kenya, Mozambique and Tanzania are all constitutionally bound to step down when their current second terms expire in 2013, 2014 and 2015 respectively. None of the presidents is likely to contest this or seek to amend the constitutions to allow them to extend their time in office. The situation in Ethiopia is more complex. Long-standing premier Meles Zenawi died in office in August 2012 after more than 20 years in power. Having personally overseen Ethiopia’s economic and political transformation, Meles leaves a formidable legacy and his successor is unlikely to wield the same level of influence. That task falls to new Prime Minister Hailemariam Desalegn, who will hold office probably until the next elections in 2015. It is as yet unclear whether he will prove to be a credible long-term successor.

![Leadership timeline](image-url)
Negotiating production contracts requires a strong legal framework that accurately reflects current market conditions. Outdated laws – such as those in Tanzania and Kenya, where legislation governing the petroleum sector was passed in 1980 and 1986 respectively – are unlikely to inspire confidence among either investors or civil society. Tanzania’s Petroleum Exploration and Production Law, which was introduced in 1980, when the country had little experience of engaging with multinationals, fails to provide a satisfactory framework for revenue management. Mozambique lies ahead of the curve, having passed its progressive petroleum law in 2001.

Although officials in both Tanzania and Kenya acknowledge the need to update legislation, in reality a lack of political will or institutional capacity hinders the process. Outdated legislation creates opportunities for unscrupulous political elites with vested interests who have little interest in increasing levels of transparency or accountability.

Current regulatory frameworks offer few satisfactory provisions for parliamentary oversight or to eliminate conflicts of interest when politicians hold business interests in the oil and gas sector. Moreover, drafting bodies routinely lack the expertise to draw up satisfactory legislation, which offers safeguards for both companies and local communities. They rely on input from NGOs, civil society and donor institutions to review and strengthen draft laws, but frustratingly, this kind of helpful input is often rejected or ignored without explanation. In addition, there is a risk of political interference throughout the process.

Bureaucratic capacity is already a major concern across the region. Existing operators have little faith in the institutional capacity of regulatory bodies such as Uganda’s Petroleum Exploration and Production Department (PEPD). Tanzania’s Petroleum Development Corporation (TPDC) is supposed to be a national oil company, but has a secondary regulatory function, which undermines its credibility. It is important for the industry regulator to be entirely independent of exploration and production operators, including the national oil company, to avoid any conflict of interest.

**CORRUPTING INFLUENCE**

The line between vested political interests and corrupt behaviour is often blurred. Managing integrity risks is crucial to doing business successfully in East Africa, where corruption continues to blight the business environment. There are signs of improvement, but the political will to stamp out corruption remains weak in most countries in the region. Uganda’s oil sector has already been tarnished by allegations of bribery that emerged from leaked diplomatic cables. Although these have been categorically denied, they nonetheless cast an air of suspicion over the integrity of the government in its handling of contract negotiations and revenue management. Quite apart from the serious legal implications, companies proven (or even suspected) of colluding with corrupt elites risk losing their social licence to operate. Civil-society groups and the media are closely scrutinising the behaviour of oil and gas companies, and any suspected foul play will provoke vigorous criticism, which could turn popular opinion against the industry generally.

Heavily bureaucratic regimes such as those in Tanzania and Mozambique are not only frustratingly slow to make decisions, but can also cause headaches for companies over integrity. In Tanzania, it is common to be confronted with numerous documents and processes, and be required to deal with a long chain of people, during official interactions. While this is often the case throughout the region, the Tanzanian bureaucracy has earned an unenviable reputation as one of the very worst performers on the continent. This means that it can be difficult to tell when a bureaucratic delay is the result of understaffing or incompetence, or is a deliberate attempt by officials to solicit a bribe. Equally, evasiveness and delays at senior levels may sometimes be deliberate ploys to angle for facilitation payments (minor payments aimed at expediting or securing the performance of a routine government action) or come as a result of bias caused by ministers’ and officials’ personal or political interests. However, they can also be face-saving tactics to disguise uncertainty or incompetence.

Civil-society groups and NGOs repeatedly point to revenue management as an area of concern. They fear that, as oil and gas revenues start to flow, weak legislation will allow political elites to establish the kind of personal fiefdoms that have proved so damaging in parts of West Africa. Despite a lengthy drafting process, Uganda has yet to pass crucial petroleum legislation six years after the Lake Albert oil reserves were proven to be commercially viable. Without a strong legal framework, there can be little oversight of the way the revenues are dispensed or spent. No East African state is yet fully compliant with the Extractive Industries Transparency Initiative (EITI), and only Tanzania and Mozambique have made progress as candidate countries. Participation in such international initiatives helps to instil confidence in investors wary of integrity risks and in civil-society groups sceptical of government intentions. There
is cause for optimism regarding the overall trajectory of anti-corruption measures in East Africa, but there is still a long way to go.

Investors in East Africa can adopt certain measures that will limit their exposure to the risks posed by corruption in the oil and gas sector. Pre-entry preparations should include a comprehensive review of all planned in-country operations, highlighting areas and situations in which personnel and sub-contractors may be vulnerable to corruption. Anticipating that delays will be inevitable when dealing with bureaucratic process and factoring them into schedules will reduce exposure to demands for facilitation payments. Full cooperation with initiatives such as the EITI will help to build popular confidence in overall revenue management, particularly with regard to supervision of payments made by foreign investors to the government.

**BUILDING FOR THE FUTURE**

The lack of established infrastructure to support East Africa’s oil and gas industry is often cited as an impediment to its development. Considerable investment is certainly needed to complement exploration and, more importantly, production of oil and gas reserves. However, while this presents challenges for existing operators, it also offers considerable commercial opportunities, and is likely to be a major growth area over the next decade.

Ambitious plans are already unfolding in Kenya, where the government has agreed a deal with South Sudan to construct a pipeline linking the South Sudanese oil fields with a proposed new ‘mega-port’ on the coast at Lamu. The new port is part of a major new infrastructure project designed to develop a historically marginalised region of Kenya, including new road and high-speed rail links that will connect Kenya to its neighbours. Although the project initially seemed more aspirational than realistic, the prospect of Kenyan oil and the gains to be made from the transit of South Sudanese oil (provided the flow is not disrupted by renewed conflict) mean that both impetus and investment potential are greater than ever before. Juba is desperate to diversify its oil-export options to reduce its reliance on Sudan, with which relations are hostile. The cost of a pipeline from South Sudan to Kenya will be enormous – conservative estimates are around $3bn – and the state of South Sudanese government finances means that most funding is likely to come from development partners such as China.

Greater regional economic and infrastructural integration would be a positive development for the overall investment environment, but competing interests and political rivalries threaten to derail the process. The East African Community (EAC), which comprises Burundi, Kenya, Rwanda, Tanzania and Uganda, is implementing common market and customs union protocols, but is hamstrung by conflicting views on its future trajectory. Although plans for a common currency are developing, with so many competing interests and personalities, the idea of a political federation is a pipe dream.

Competition is rife between Kenya, Uganda and Tanzania to establish themselves as the hub for regional investment, particularly in oil and gas. Even before Kenya announced that it had discovered oil, the country was firmly regarded by investors as East Africa’s commercial and infrastructural hub. Few doubt that Kenya has the capacity to undertake long-term projects and, if the oil discoveries prove to be commercially viable, that it will seek to develop the resource quickly. The country already has experience of constructing and managing pipelines, and has a working refinery at Mombasa.

Uganda, on the other hand, does not enjoy any of Kenya’s advantages, and the government has yet to announce concrete plans for infrastructure that will enable oil companies to facilitate field development, let alone a final infrastructure plan for the sector.

### Regional EITI status

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Source: Extractive Industries Transparency Initiative
The Ugandan government plans a domestic refinery, but oil companies dispute its desirability. The government wants to harness the maximum potential revenues by refining oil domestically and distributing it to its neighbours. However, there are fears that domestic refining will only complicate the production process further, with room for even more political interference. The oil discoveries in Kenya are likely to cast fresh doubt on the viability of a refinery in the hinterland of landlocked Uganda, which may prove less viable than one in Kenya. Depending on Kenya’s plans to commercialise its own reserves, Uganda is in danger of losing the regional market that it insisted would be able to absorb its output. There are already doubts that Ugandan oil would be competitive against imports brought in through Mombasa, and this would be greatly compounded were Kenya to produce its own output. The quantities of oil discovered so far in Kenya’s Turkana region are believed to be extremely large, possibly even greater than those found in Uganda’s Lake Albert.

Meanwhile, Tanzania risks being swamped by better educated and more technically skilled workers from Kenya should the EAC pave the way for free movement of labour. Tanzania lags well behind Kenya on development indicators, particularly education and skills training. As a result, it suffers from a serious shortage of suitably qualified workers to staff oil and gas companies. Kenya has a larger pool of talent to draw on and, with no concrete local-content requirements enshrined in Tanzania’s petroleum legislation, the local workforce would be likely to suffer from greater integration.

New East African oil discoveries could affect regional relationships and alliances in several ways. Kenya’s desire to supply the region with its own oil could push Uganda’s focus more towards eastern Congo (DRC). To make its own refining and other value-adding infrastructure more viable, Uganda has a growing vested interest in Congolese oil production, which would probably have to be piped into Uganda. This is more likely following South Sudan’s pipeline agreement with Kenya, which is likely to have quashed Uganda’s hopes of seeing South Sudanese oil piped through its territory. Uganda will be hoping that Kenya’s recent find is not replicated in Tanzania, or it risks seeing itself once again consigned to the region’s economic periphery.

The success of regional integration will ultimately require a huge shift in political mindsets with regard to cross-border trade, shared use of regional infrastructure, institutional efficiency and the development of regional economies of scale. That there will be relative winners and losers appears unavoidable, whatever form the region’s oil sector and infrastructure ends up taking. Kenya’s ambitious infrastructure plans provide a source of encouragement. However, the EAC is unlikely to be able to persuade all its members – and would-be members such as South Sudan and Ethiopia – to adopt a collective approach, to the eventual detriment of investors in the oil and gas sector.

Lessons from the Niger delta show the importance of effective community engagement by both governments and companies in oil-producing areas. While militancy on the scale witnessed in Nigeria is unlikely in East Africa, there can be no room for complacency. Oil-exploration activity has already been the target of attack in Ethiopia: the separatist Ogaden National Liberation Front (ONLF) in April 2007 killed 74 workers at a drill site during a raid on the Abole oil field in the Ogaden region. Such incidents are rare and are largely the result of exploration in a part of Ethiopia where the government has at times struggled to exert authority. The situation in the Ogaden is improving, but as other East African oil and gas fields move into production, poorly handled community engagement risks provoking a hostile reaction, and even violence.
As well as posing an immediate security threat to operators, ineffective community engagement strategies can cause reputational damage to companies accused of not taking their social responsibilities seriously enough. Unfortunately for investors, handling of sensitive community-related issues often lies beyond their control. In Uganda, disagreement over land-access rights and revenue-sharing threatens to become a serious flashpoint. The political leadership of the Bunyoro Kingdom, the region in which the Lake Albert oil fields are located, has clashed with the government and demanded a greater share of revenues and state-led development. The absence of formal land titles in many parts of Uganda creates confusion for local landholders, while allowing unscrupulous prospectors to lay dubious claim to potentially valuable plots. Managing local expectations is also key to positive community engagement. Museveni’s jubilance following the oil finds in 2006 (he held a national prayer meeting to give thanks) has fuelled wild hopes among Bunyoro communities of revitalised infrastructure, abundant employment opportunities and immediate cash in-flows. Across the region, companies must be wary of government attempts to win political capital by over-emphasising the positive effect of oil discoveries on the local community and creating false expectations of wealth.

Engagement with NGOs over any negative aspect of oil and gas operations is equally important. Civil-society groups focusing on this sector are nascent, but are starting to play a leading role in holding governments and industry players to account over their commitments to transparency and community engagement. Through early and active consultation they can be a useful conduit for companies to interact with communities and assuage concerns over social and environmental impact. This is particularly important for companies operating in remote areas such as northern Kenya, where communities have almost no experience of engaging with international investors. Pastoralist communities in the Turkana region are sensitive to any outside interference in their already fragile way of life. Banditry already poses a threat in such areas, since they often lie outside formal state control, and failure to engage with pastoralists from the outset risks pitting investors against disaffected communities.

The strategic value of oil and gas reserves at a national level has focused government attention on the protection of these assets against security threats. On the one hand, this is good news for investors as there is little danger of the state neglecting its responsibility to provide safe operating environments in the oil and gas sector. On the other hand, state security forces are liable to adopt an over-zealous approach that could expose companies to reputational damage. Human-rights groups have heavily criticised the Ethiopian National Defence Force (ENDF) for its uncompromising tactics towards insurgents in the Ogaden region. In its bid to remove the insurgent...

**Worldwide Governance Indicators, East Africa, 2011**

<table>
<thead>
<tr>
<th>Country</th>
<th>Voice and Accountability</th>
<th>Political Stability and Absence of Violence/Terrorism</th>
<th>Government Effectiveness</th>
<th>Regulatory Quality</th>
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**Definitions**

1. **Voice and Accountability** – capturing perceptions of the extent to which a country’s citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association and a free media.
2. **Political Stability and Absence of Violence/Terrorism** – capturing perceptions of the likelihood that the government will be destabilised or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.
3. **Government Effectiveness** – capturing perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies.
4. **Regulatory Quality** – capturing perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
5. **Rule of Law** – capturing perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
6. **Control of Corruption** – capturing perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as “capture” of the state by elites and private interests.

Source: Worldwide Governance Indicators 2011
threat and create a safe operating environment, the ENDF stands accused of indiscriminately targeting civilian communities. The direct association of oil companies with the government meant that ENDF operations undermined their social licence to operate and provoked criticism by international NGOs.

The area around Uganda’s Lake Albert oil fields is now heavily militarised, and Museveni has dispatched a battalion of elite special forces commanded by his son to take responsibility for security in the area. The government points to the threat of rebel incursions from neighbouring Congo (DRC) by way of justification, but the new military base is also well placed to crush any signs of local dissent and enforce presidential authority. Offshore operators are also vulnerable to reputational damage from the actions of security forces. Fears that pirates in the Indian Ocean could turn their attention to vessels and infrastructure supporting oil and gas exploration have prompted an escalation in counter-piracy operations carried out both by host government naval forces and private security providers. Inexperienced security forces risk wrongly identifying pirates or failing to comply with international maritime law, which could expose the companies on whose behalf they are working.

Finally, there are signs that the string of discoveries in coastal areas is reigniting historical separatist agitation. Both Kenya and Tanzania face challenges to their authority from populations in the coastal region over demands for greater autonomy and even outright secession. In Kenya, a group from Coast province, the Mombasa Republic Public Council (MRC), is calling for a review of the historical agreement binding the coastal region to the central government. The MRC was declared illegal in 2010, but mounting opposition and violent protest resulted in the courts overturning the ruling in July 2012. In Tanzania, there are growing calls for local control over political and economic policy on the island of Zanzibar, which enjoys political union with the Tanzanian government, but has negotiated autonomy over certain areas of policy-making. Violent protests in May were linked to an Islamist separatist group, Uamsho, which is calling for complete secession of the island state. Both the MRC and Uamsho cited the potential existence of oil and gas, and the prospect of missing out on a share of lucrative exploration contracts with foreign companies, as reasons for their protests.

CONCLUSION

The steady flow of positive news regarding oil and gas discoveries is clear testament to the commercial opportunities that exist in East Africa. As exploration intensifies and countries move towards production, investment in the region will grow further. Yet, as outlined above, East Africa remains a complex operating environment. While the threats might not be as high profile as those in other parts of the continent, companies must navigate a number of diverse challenges ranging from political risk to physical insecurity. Without forward planning, such obstacles can seriously undermine the business case for oil and gas investors.

With its large discoveries of oil back in 2006, Uganda finds itself in the curious situation of being the ‘old hand’ in this nascent oil and gas market. However, the way that the government has approached the industry in the intervening years has been far from ideal. Concerns remain over how far neighbouring East African countries – especially Tanzania and Mozambique, which are equally resource rich – will go down the same path as Uganda. Neither country is likely to see the oil and gas sector suffer the same degree of political interference as Uganda, but investors should be alert to the warning signs, particularly any indications that levels of transparency are reducing. Political interference, corruption allegations, outdated legislation, slow decision-making and weak institutions have all hampered the development of the Ugandan oil industry to the frustration of operators. Such conditions are not unique to Uganda and if the East African market is to fulfil its potential, it will require a concerted effort on the part of governments and the private sector alike to create a viable business environment.
COUNTRY SNAPSHOTS
The government and prospectors alike welcomed the announcement in March 2012 that Kenya had finally discovered oil after many years of exploration. However, the reserves in Kenya’s northern Turkana region have yet to be determined as commercially viable, and the director of the National Oil Corporation of Kenya (NOCK) concedes that, even if that were the case, production would not begin until 2018. Nonetheless, the signs are promising, with early indications suggesting that the Ngima-1 well in Turkana may hold reserves equivalent to those beneath Uganda’s Lake Albert. If the reserves prove commercially viable, Kenya will be well positioned to advance towards production. The government has plenty of experience in handling foreign investors across a range of other sectors, and has stronger and more technically competent institutions than its neighbours. With an existing refinery in Mombasa, and plans for new refining capacity to accompany the port at Lamu, there is no need for concern over taking crude product to market.

However, there are other potential problems on the horizon. Elections are scheduled for March 2013 and there are fears of a repeat of the 2007-08 post-election violence that left more than 1,100 people dead. Although progress has been made towards national integration, and the 2013 polls are unlikely to be as violent as in 2007, the political situation remains fragile and elites continue to stoke ethnic rivalries to win votes and put pressure on the local electorate. Turkana region suffers from frequent bouts of inter-communal violence between pastoral communities competing for access to resources such as land and water, as well as cattle. The government has struggled to rein in banditry and exert its state authority, which risks leaving operators in the area exposed to security threats. Investors in the oil and infrastructure sectors will need to manage community relations carefully and be aware of the potential for tensions over pastoralist land rights.

Despite a steady improvement in governance, graft continues to plague the operating environment. So far, the oil and gas sector has largely slipped beneath the radar, but the recent discoveries have inevitably boosted the industry’s profile and unscrupulous elites may try to exploit commercial interest for personal gain.

Having long played second fiddle to Kenya when it comes to business and foreign investment, Tanzania is relishing the prospect of a natural-gas boom. Its reserves lie for the most part offshore, though there is some onshore oil and gas exploration. The Ministry of Energy in June announced that a run of new discoveries took the total recoverable reserves of gas to 28 trillion cubic feet (tcf), of which 3.5 tcf have already been commercialised at the Songo Songo and Mnazi Bay gas fields.

The potential rewards for investors are not in doubt but, despite enjoying enviable political stability, Tanzania remains some way behind Kenya as an overall investment environment because its infrastructure is often ill-equipped to handle the demands of the extractive industries. The provision of basic services such as electricity is temperamental at best, while facilities at the port of Dar es Salaam are struggling to keep up with those elsewhere on the continent. Despite signs of gradual progress, the government is realising only too late the impact of decades of under-investment in education, which has resulted in few technocrats with the skills and training to work in specialist positions either at the Ministry of Energy or for foreign oil and gas companies. A new regulatory framework is urgently needed, and natural-gas exploration and production laws are already in the pipeline. Although the government plans to table the legislation before parliament in October 2012, the timeline is optimistic and it may be at least another year before it is signed into law.

Tanzania’s history of political stability should help it appeal to foreign investors, but trouble is looming between the government and the administration of the island state of Zanzibar. A constitutional-review process and the prospect of natural-gas revenues starting to flow have reignited a dispute over sovereignty and revenue-sharing. The Zanzibaris are seeking greater autonomy and, ultimately, control over any revenues accrued from resources that lie in their waters, but the Union government (the administration that includes representatives from both Zanzibar and the mainland) insists on an even share. The deadlock is creating uncertainty for companies seeking to explore the waters around Zanzibar and has temporarily stopped any licences being awarded in blocks around the island. Political tensions are rising over the issue, which may not be resolved for many months.
Although most successful oil and gas exploration has taken place elsewhere in East Africa, Ethiopia is a frontier market that retains considerable potential. Exploration has traditionally focused on the harsh landscape of the Ogaden region. However, activity also takes place in the south-west, close to the Kenyan border and not far from the region where Kenyan discoveries have recently been made. The government will hope to build on existing proven gas reserves in the Ogaden and has made a concerted effort to develop an economic development strategy based on attracting investment in the extractive industries. While the government can be difficult to do business with in other domains, oil and gas companies can expect a more sympathetic hearing.

Despite Meles’ death, Ethiopia remains relatively politically stable. The ruling coalition is under no serious pressure from opposition groups, which are too weak or divided to pose a threat to what should be a relatively smooth transition. Desalegn is a generally uncontroversial consensus figure, while the ruling-party elite will continue to dictate overall policy direction from behind the scenes.

The security situation in the Ogaden region will remain a major issue of concern for investors. Most exploration has gravitated to the region, which has experienced a long-running insurgency by the ONLF; the group has fought for regional self-determination since 1994. Oil and gas exploration in the region has raised the stakes for both the government and insurgents. Rebel threats to target companies prompted a vicious military counter-insurgency campaign. Government claims that stability has now returned to the Ogaden region are wide of the mark, with a steady stream of reported clashes between insurgents and government security forces, as well as inter- clan conflict. However, signs of improvement should encourage investors. Reports of a final peace deal with the ONLF are premature, but the group is deeply divided and its ideological agenda of regional secession has lost momentum.

The discoveries of oil beneath Lake Albert in 2006 set the pace for the East African petroleum industry and triggered a flurry of activity across the region. While Uganda had long been suspected of harbouring significant reserves, the announcement that the Albertine region could produce between 200,000 bpd and 350,000 bpd caused investors to take notice. The government has since leased blocks to major international oil companies, but the path towards production has been rocky. The first plans unveiled in 2006 would have seen oil flowing in 2009. This date has been routinely pushed back, with government pronouncements generally far more optimistic than those from oil companies. Even the latest suggested date of 2017 appears to be a best-case scenario.

Debate over management of the petroleum sector has raged in Uganda over the last year. Museveni in October 2011 faced an almost unprecedented backlash from parliament over his refusal to disclose the details of production-sharing agreements. Lawmakers issued a moratorium on the signing of any new deals, though in a display of power Museveni simply ignored this move. While the contractual debates rolled on, politicians from the Bunyoro region adopted an increasingly belligerent stance over revenue-sharing. The region’s traditional king in June 2012 took the unprecedented step of appearing before parliament to demand a 12.5% share of revenues accrued from deposits in the region, while lawmakers warned of the potential for unrest if the demands were not met. The government has repeatedly failed to address questions of revenue-sharing since confirming the commercial viability of its oil reserves in 2006, and crucial legislation has yet to be passed. Threats of popular unrest will only exacerbate the government’s security-focused approach to engagement in the oil regions. The area is already heavily militarised, with access restrictions in place and a strong presence from intelligence agencies. Renewed rebellion next door in eastern Congo (DRC) is driving a further military build-up that is unlikely to be scaled back significantly.

Decision-making has not proved Museveni’s strong point when it comes to the oil sector. Despite his personal grip on policy, he has repeatedly stalled
over key questions such as whether to refine oil domestically or export crude product. The government had hoped that its reserves would be able to service regional demand, but it appears to have scaled back its ambitions with plans for a refinery that would serve domestic demand only. Meanwhile, the long-awaited Petroleum Exploration, Development and Production Bill may finally pass this year, paving the way for a new licensing round to begin in 2013.

The government has made a concerted effort to attract investment, and its spectacular gas discoveries in the Rovuma Basin have made the country something of a poster child for East African oil and gas exploration. It is ideally positioned to export gas to the enormous South African market which urgently needs supplies to address its domestic power deficiencies. Meanwhile, South-East Asian countries, particularly Japan, are increasingly likely to look to Mozambique’s offshore gas reserves as a viable option to diversify their energy sources. Although Mozambique is touted as a rival to Australia as a liquefied natural gas exporter, it is likely to be a number of years before the country can challenge or overtake existing exporters. Endemic corruption and limited oil and gas infrastructure will pose the most significant challenges to operators in the short-to-medium term.

The government’s infrastructure was wholly inadequate for the recent spike in investment in the extractive sector. The potential of recent discoveries and regional and international demand for gas have prompted foreign companies to take the lead on infrastructure development. The government’s support for these initiatives highlights its acknowledgment that the future lies in the export market and that it has limited capacity to develop the infrastructure required to achieve this goal. The energy deficit in South Africa is likely to speed up the development of a pipeline from the Pande and Temade gas fields to Gauteng province in South Africa. Power and pipeline developments in the north are expected to gather pace as operators prepare to service global markets over the next few years. The government will continue to back these investments for the time being. However, operators can expect minor delays caused by bureaucratic inefficiencies and, on occasion, environmental activism both onshore and offshore.
POLITICAL RISK

Political risk evaluates the likelihood of state or non-state political actors negatively affecting business operations in a country through regime instability or direct/indirect interference, and also evaluates the influence of societal and structural factors on business. State actors can include domestic and foreign governments, parliament, the judiciary, regulatory bodies, state and local administrations and the security forces. Non-state actors can include insurgent groups, labour forces, campaign groups, lobbies, other companies, organised criminal groups and international organisations. Societal and structural factors can include corruption, infrastructure, ease of establishing and maintaining a functioning business, and bureaucratic and business culture. The impact on companies can include judicial insecurity, corruption, reputational damage, expropriation and nationalisation, contract uncertainty, international sanctions, bureaucratic delay, partiality in contract and tender awards, campaigns and protests. Political risk may vary for companies and investment projects according to factors such as industry sector and investor nationality.

INSIGNIFICANT

The environment for business is benign. For example: political stability is assured, investor-friendly policies are entrenched, there is no threat of contract re-negotiation or repudiation, and infrastructure for business is excellent.

LOW

Political and operating conditions are broadly positive. Occasional and/or low-level challenges do not significantly impede business. For example: government policies are investor-friendly with some exceptions, contracts are generally respected, non-state actors have little adverse influence over government decisions, infrastructure is generally robust or there is little risk of reputational damage.

MEDIUM

While the environment provides generally sound conditions for business, significant challenges can and do emerge. For example: hostile lobby groups exert disproportionate influence over government policy, political instability delays essential reforms, contracts are subject to uncertainty or occasional change, elements of the infrastructure are deficient, or the activities of unions or protest groups impede operations.

HIGH

The political and operating environment presents serious and challenging conditions for business. For example: there is a credible risk of contract repudiation or re-negotiation by state actors, political instability threatens fundamental alterations to the nature of the state, government policy is capricious or harmful to business, corruption is endemic across all levels of officialdom, or regulations are onerous and their implementation is capricious.

SECURITY RISK

Security risk evaluates the likelihood of state or non-state actors engaging in actions that harm the financial, physical and human assets of a company, and the extent to which the state is willing and able to protect those assets. Actors that may pose a security risk include political extremists, direct action groups, the security forces, foreign armies, insurgents, petty and organised criminals, protesters, workforces, local communities, indigenous groups, corrupt officials, business partners, and in-country company management staff. The impact of security risk on companies can include war damage, theft, injury, kidnap, death, destruction of assets, information theft, extortion, fraud, loss of control over business, and disruption to operations caused by damage or denial of access to buildings or vital infrastructure caused by terrorist attacks, threats or official responses. Security risk may vary for companies and investment projects according to factors such as industry sector, investor nationality and geographic location.

INSIGNIFICANT

The security environment for business is benign. For example: the authorities provide effective security, there is virtually no political violence, public disorder is rare and there are no known active domestic groups or issues likely to fuel terrorism.

LOW

Security conditions are broadly positive and occasional and/or low-level attacks do not significantly impede business. For example: the authorities provide adequate security, organised crime only marginally affects business and protest activity rarely escalates into threatened or actual violence. Rare but large-scale terrorist attacks may pose indirect threats to personnel or assets, or low-level attacks do not target business and are not aimed at causing casualties.

MEDIUM

Aspects of the security environment pose challenges to business, some of which may be serious. For example: there are some deficiencies in state protection, organised criminal groups frequently target business through fraud, theft and extortion, domestic terrorist groups stage regular attacks that cause disruption to (but do not target) business or there are infrequent large-scale attacks and/or opportunistic small-scale attacks on foreign or business assets and personnel.

HIGH

The security environment presents persistent and serious challenges for business; special measures are required. For example: state protection is very limited, insurgents are engaged in a sustained campaign affecting business, kidnap poses a severe and persistent threat to foreign personnel, terrorist groups stage regular attacks against foreign or business assets, or weak security forces are incapable of dealing with the terrorist activity.

EXTREME

Security conditions are hostile and approaching a level where business is untenable. For example: there is no law and order, there is outright war or civil war, personnel constantly face the threat of targeted and potentially life-endangering violence, a terrorist group (or groups) is staging a sustained, high-intensity campaign that severely hinders business, or terrorists frequently target foreign personnel or business activity.
**EAST AFRICA: FORECAST RISK RATINGS 2012-13**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>POLITICAL RISK</th>
<th>SECURITY RISK</th>
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<tbody>
<tr>
<td>Ethiopia</td>
<td>M</td>
<td>M; H in Afar region (north of Semera), Somali region, areas bordering Eritrea, Kenya, Sudan</td>
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<td>M; H in Nairobi, northern and eastern areas</td>
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<td>Uganda</td>
<td>M</td>
<td>M; H in northern, north-eastern areas and border with Congo (DRC)</td>
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**EAST AFRICA RISK FORECAST KEY**

**SECURITY RISK**
- Insignificant
- Low
- Medium
- High
- Extreme

**POLITICAL RISK**
- Insignificant
- Low
- Medium
- High
- Extreme

**MARITIME SECURITY RISK**
Darker areas indicate higher level of risk.
## Control Risks’ offices

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