ESG Concerns Limit East African Oil and Gas Outlook

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East Africa was one of the fastest-growing regions of Africa leading up to the COVID-19 pandemic, and many countries that comprise this region have compelling commodity potential. How might this transformation happen? And what are the risks to investors in emerging markets debt?

East Africa is the eastern subregion of the African continent. Although 19 territories make up East Africa in the United Nations statistics division scheme of geographic regions, we are focusing on three today: Kenya, Uganda, and Tanzania.

Why does East Africa matter? We tend to overweight frontier markets because we believe the risk premium there is structurally mispriced.

East African countries are generally oil importers, with the exception of some hydrocarbon production out of Tanzania. But in these countries, oil and gas exports have the potential to be transformational.

Over the short term—say, the next two to three years—one consideration when we're evaluating the performance potential of the external sectors and their current account deficits is the fact that these countries are not commodity exporters, and thus can potentially suffer from a deterioration in terms of trade as oil prices rise.

Over the medium term, these countries' success in developing their oil-exporting capacity could be transformative in galvanizing large amounts of export revenue, as well as boosting government revenue (if done transparently, and in a way whereby there is a sound public finance management system to account for those inflows).

However, we're still reluctant to be very optimistic about those outlooks. At times in the past in Africa, the expectation of large amounts of revenue has not ensured a sound fiscal path. Mozambique and Ghana come to mind; there, great expectations of substantial inflows fueled expenditures and widened fiscal budgets. We would loath to see that occur across East Africa.

We must also remember that oil and gas were discovered long ago in these countries, but they still have not become oil exporters. Uganda first found oil in 2006; 15 years later, we're discussing a potential financial investment there that would galvanize large amounts of foreign direct investment into the sector.

But it's highly uncertain, in my view, because we are also at a very different point in time when it comes to considerations for new investments in oil and gas—specifically, around climate change. Banks are changing their policies and decarbonizing their portfolios, as are investors. So, we are acutely aware of the East African oil and gas sector being negatively impacted by a focus on green products.

Uganda's GET FiT program—jointly developed by the government of Uganda, Electricity Regulatory Authority, and KfW Development Bank to leverage private investment into renewable energy generation projects in Uganda—is also facing large uncertainty because of the country's tax regime; there are also practical issues regarding the construction of the East African Crude Oil Pipeline (EACOP), which is intended to transport crude oil from Uganda's oil fields to the Port of Tanga, Tanzania, on the Indian Ocean.

In sum, East Africa could have substantial commercial oil production by 2025. That in and of itself could be quite a positive from an investor perspective because it generates foreign proceeds that these countries could use, particularly to service some of their existing debt.

But there are many hurdles to be crossed, and looking at a longer-term horizon, as managers of emerging markets debt, we are cautious about these countries' ability to deliver and concerned around the environmental hurdles that these oil and gas projects face.

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