



Contracts Curse

Uganda's oil agreements place profit before people

February 2010



Civil Society Coalition on Oil in Uganda



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Introduction

‘With production due to start within the next 12 months, the clear lack of environmental protection provisions, accountability of oil security forces and the weak economic terms are highly worrying.’

This report aims to provide an in-depth analysis of Uganda’s Production Sharing Agreements (PSAs) covering oil development in the Albertine Graben. PLATFORM has investigated the contract terms relating to economics, sovereignty, human rights and the environment. We examine relevant paragraphs in the Ugandan context, in relation to current oil company practice in Uganda and in comparison to contract terms in other countries. It explores the balance of rights and responsibilities between the Ugandan government and the oil companies, and who carries which risks.

Until November 2009, the content of the Production Sharing Agreements remained a closely guarded secret, with both the Ugandan government and the oil companies opportunistically only releasing decontextualised snippets. PLATFORM obtained and released draft copies of Heritage’s 2004 Block 3A PSA (containing a comparison with PSA terms for Block 1 and Block 2), Dominion’s 2007 Block 4B PSA, and a draft of the Tullow Block 2 PSA. A number of sources, including off-the-record government responses, a signed statement from the Ministry of Energy, confidential audit reports and investment bank analyses, have confirmed that these draft versions of the contracts are indeed very close, if not identical, to the signed PSAs. This report is based primarily on clauses from the Block 3A contract.

New and larger oil companies are trying to buy into Ugandan oil in 2010. Heritage Oil has invited Italian company ENI to buy its stake, while Tullow is apparently supporting a rival bid by US giant Exxon. These oil majors are aiming to buy out Heritage’s holdings directly, which means they would avoid any renegotiations or the need to go through the Ugandan government. However, this acquisition presents an opportunity to raise new concerns about the existing terms of the contracts that are being bought into. It is in that context that the analysis and urgent recommendations made in this report need to be campaigned upon.

Civil society organisations in Uganda continue to bring legal challenges to ensure that the full PSAs are made public. There are currently three suits outstanding against the government, from the African Institute for Energy Governance, Greenwatch and the Daily Monitor newspaper, all using the Access to Information Act.

Apart from revealing those parts of the oil agreements that are not yet in the public domain, particularly with regard to security provisions, these law suits have the potential to create an important legal precedent. At the same time, it is important that the information that is currently available - however incomplete - is used now to create the conditions for renegotiation and a more informed critique of both the government and the companies involved. With production due to start within the next 12 months, the weak economic terms and the clear lack of both environmental protection provisions and accountability of oil security forces are all highly worrying.

Oil in Uganda

Lake Albert in Uganda was considered an attractive oil prospecting region for a long time, given the natural oil seepage in the area. BP and other companies explored the area in the 1930s with the first well drilled in 1938, before World War II intervened.

The late 1990s and early 2000s saw renewed interest in Uganda's potential natural resources, with contracts signed with Hardman Petroleum, Energy Africa, and Heritage Oil. The Government of Uganda licensed oil exploration and extraction through contracts known as Production Sharing Agreements (PSAs). See Appendix 1 for further background on PSAs.

Exploration Area 3 was licensed to Heritage Oil through a PSA in 1997. This was renegotiated in 2004 with Heritage and Energy Africa (now owned by Tullow). A second PSA was signed in 2001 with Hardman Resources (now owned by Tullow), covering Exploration Area 2. Exploration Area 1 was licensed in 2004 to Heritage and Energy Africa. The PSA covering Block 4B was signed in 2007 with Dominion Uganda.

The licenses around Lake Albert have since been consolidated: with Blocks 1, 2 and 3A held by Tullow and Heritage. The same oil companies also hold licences on the Congo side of Lake Albert, although these were disputed in recent years following military clashes. A joint production area with Uganda is envisaged by the Ngurdoto Agreement signed in September 2007 but progress has stalled while Kinshasa decides on potential new partners. PLATFORM will release these contracts in 2010.

Exploration activity by Tullow and Heritage led to major discoveries across the Lake Albert basin from 2006 onwards. The Kingfisher find was discovered in Block 3A in February 2007, with 200 million barrels of confirmed oil. Kasamene in Block 2 followed in August 2008 with high flow rates, and Buffalo/Giraffe in December 2009 proved 350 million barrels of oil equivalent. These have since been expanded, and drilling continues. Tullow's August 2009 Factbook predicts reserves of 1,700 million barrels for Blocks 1 and 2.

None of these contracts have been made public by either the government or the oil companies. However, PLATFORM has obtained the contract terms and made them available to the public through www.carbonweb.org/uganda/

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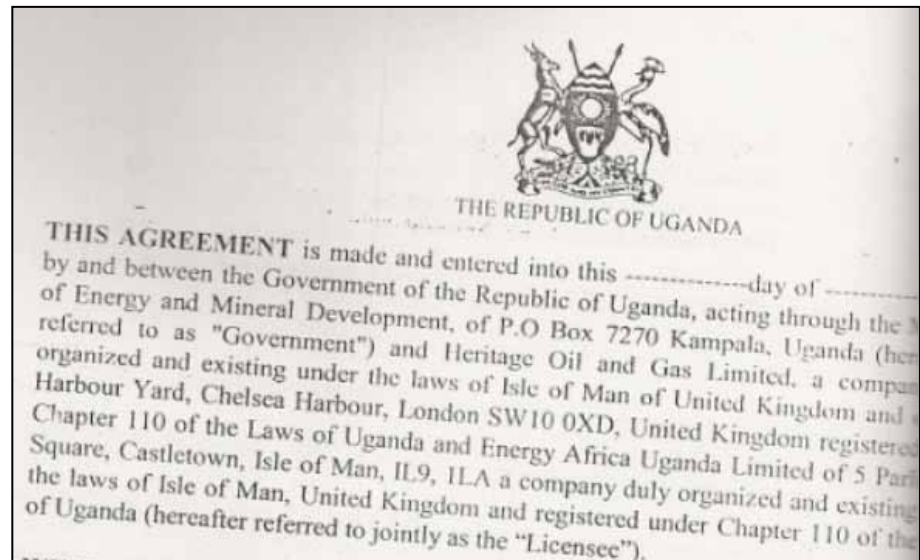
Existing PSAs in Uganda

Block 1	Heritage (50%), Tullow (50%)
Block 2	Tullow (100%)
Block 3A	Heritage (50%), Tullow (50%)
Block 4B	Dominion Uganda
Block 5	Tower Resources & Global Petroleum

Analysis of contract

'Host governments are often attracted by signature bonuses, as they represent hard cash up front. The Ugandan government seems to have been similarly distracted...'

1) AGREEMENT



This contract was made and signed by the Government of the Republic of Uganda, through the Minister of Energy and Mineral Development, Heritage Oil and Gas Limited and Energy Africa Uganda Limited (now owned by Tullow Oil).

- This means that Uganda as host government has assumed contractual liability as a direct party to the agreement. While this is not uncommon, it is good practice for the host government to avoid direct responsibility and unlimited liability by engaging a state-owned enterprise (usually the national oil company) as contractual partner instead. Operating as a separate legal entity, this would limit the Ugandan liability, as only the enterprise's assets can be seized.¹
- For example, the 1994 ACG contract signed in Azerbaijan was between a consortium of oil companies led by BP and the State Oil Company of Azerbaijan (SOCAR). PSAs in Libya are signed by the Libyan National Oil Corporation.²

2) FISCAL TERMS (ARTICLES 9-14)

ARTICLE 9 – SIGNATURE BONUS

Block 3A PSA includes a \$300,000 signature bonus, while Block 2 carried a \$200,000 bonus, to be paid upon signing the contract.

- Host governments are often attracted by signature bonuses, as they represent hard cash up front. The Ugandan government seems to have been similarly distracted, as the Minister described the \$300,000 bonus of Block 3A as a “significant improvement of the fiscal terms” compared to the original Block 3 (no signature bonus).³



‘It currently appears that the government will not exercise its right to a joint venture. By refusing this possibility, the government is effectively handing over a significant portion of revenues to the private companies.’

ARTICLE 11 – STATE PARTICIPATION

ARTICLE 11

State Participation.

Government or its Nominee may elect to enter into a Joint Venture Agreement with Licensee thereby allowing for State Participation for no more than fifteen percent (15%) and Government shall inform Licensee of its decision in writing within 120 days of the receipt of the application for a Production Licence. Government or its Nominee shall be entitled to participate in Development Area by Development Area. Licensee agrees to carry the costs of Government or its Nominee through development to production. These costs are recoverable

According to the contract, the Ugandan government could choose to participate in the oil developments with a 15% stake, without providing upfront investment. The Block 4 contract allows state participation up to 20%.

- The benefits of this option are that the Ugandan state receives a greater proportion of revenues, shares in the private company’s profitability while ensuring a more even sharing of the potential ‘upsides’ - the chance that the project succeeds. Host governments will often insist on developing oil reserves through joint ventures, with a national oil company participating. The proportion held by the state company varies widely, from 5-80%.
- A frequent stipulation, particularly where the private company is the dominant partner, is that the government’s portion of development costs are “carried”, i.e. fronted by the private oil company. The private company recoups these costs through ‘cost oil’, and the state company is responsible for ongoing production costs once the oil project is up and running.
- Entering a joint venture also allows Uganda to develop greater domestic expertise in oil production. This enables the government to better understand the technical details of the business, reducing the likelihood damaging deals in the future.
- It currently appears that the government will not exercise its right to a joint venture. By refusing this possibility, the government is effectively handing over a significant portion of revenues to the private companies.

ARTICLE 12 – COST RECOVERY

12.2 All Exploration, Development, Production and Operating expenditures, as defined in Annex C, incurred by the Licensee shall be recovered from 60% of gross oil production and 70% for gas after deduction of the Royalty specified in paragraph 10.1.

12.3 The Licensee shall carry forward to subsequent years all unrecovered costs until full recovery is completed



This paragraph means that after payment of the royalty, up to 60% of the remaining oil can go towards covering costs incurred during exploration, development and operation. If the companies have greater unrecovered costs than can be reclaimed in any one year, the difference is carried forward to subsequent years. Allowable contract expenditures that can be included in this “cost oil” (are “expensable”) are laid out in Appendix C Articles 2, 3 & 4.

- When the cost oil total is increased, this reduces the quantity of oil remaining as “profit oil”. As the profit oil is split between the companies and the state, the cost of “allowable expenditures” is passed on to the state in the form of reduced profit oil. As the split of profit oil is tilted towards the state, increased costs are borne primarily by the state.
- The question of what counts as “expensable costs”, and how the government checks this is therefore a crucial issue. It is normal practice for companies (in the context of PSAs) to try to profit from ‘cost oil’. One of the reasons that multinational companies spend so much money on accountants is so that they can inflate the profits from this process. There are various ways of doing this – one is by trying to recover costs that should not be expensable. Another way is to hire an affiliated company as a contractor, and pay them a rate by which they can make a profit.
- An Ernst & Young audit of Heritage Oil’s exploration activities in Uganda between September 2004 and October 2006 found that Heritage had overclaimed cost recoverable expenditure by \$586,511 and warned of the “risk of inflating costs and expenses, more especially costs incurred outside Uganda.” The auditors rejected Heritage’s attempt to include Corporate Social Responsibility (CSR) spending as cost recoverable, warning of “the potential of recoverable expense being overstated if undefined costs are included in the recoverable costs.” CSR expenditure is regularly used to boost the reputation and image of operating companies, so claiming back these costs (at the expense of the state) is particularly reprehensible.

‘An Ernst & Young audit of Heritage Oil’s exploration activities in Uganda between September 2004 and October 2006 found that Heritage had overclaimed cost recoverable expenditure by \$586,511 and warned of the “risk of inflating costs and expenses, more especially costs incurred outside Uganda.”’

(i) Legal Expenses

All costs and expenses of litigation and legal or related services necessary or expedient for the producing, perfecting, retention and protection of the Contract Area, and in defending or prosecuting lawsuits involving the Area or any third party claim arising out of activities under the Agreement, or sums paid in respect of legal services necessary or expedient for the protection of the interest of Licensee are recoverable. Where legal services are rendered in such manner as to be necessary or expedient for the protection of the interest of Licensee, the costs and expenses of such services shall be recoverable.

According to this paragraph buried in an Annex, “All costs & expenses of litigation [...] in defending or prosecuting lawsuits involving the Area [...] are recoverable.”

- This means that if any individual or institution in Uganda, including a government ministry, feels it necessary to take the oil



'...the profit sharing terms provide no check for excessive company profits at the expense of Uganda – for example at times of high oil prices. Even the International Monetary Fund, an institution predisposed to supporting corporate demands and processes of economic liberalisation, admits in a confidential report that this is a major flaw with the current PSAs.'

company to court (e.g. for breaking Ugandan environmental laws and polluting Lake Albert), the oil company can claim employment of defense lawyers as a cost – thus transferring most of the expense to the state.

- As the paragraph cited refers to “prosecuting lawsuits” as well as “defending”, it appears that if the oil company sues or prosecutes Ugandan citizens, companies or government, the expense will also be covered by cost oil.
- This is further confirmed by the lack of inclusion of legal expenses in Annex C 4.2 “Costs not Recoverable”.

ARTICLE 13 – PRODUCTION SHARING

ARTICLE 13
Production Sharing

After the cost recovery specified in paragraph 12.2, the following Government/Licensee split will apply on the remaining total daily production (Profit Oil).

Production BOPD	Government Production Share	Licensee Production Share
(i) Where production does not exceed 5,000	46%	54%
(ii) Where production is higher than 5,000 but does not exceed 10,000	48.5%	51.5%
(iii) Where production is higher than 10,000 but does not exceed 20,000	53.5%	46.5%
(iv) Where production is higher than 20,000 but does not exceed 30,000	58.5%	41.5%
(v) Where production is higher than 30,000 but does not exceed 40,000	63.5%	36.5%
(vi) Where production is higher than 40,000	68.5%	31.5%

The Gov...

After paying the royalty and cost recovery, the remaining ‘profit oil’ is split incrementally according to the remaining daily production of barrels per day. Thus the government’s share of profits goes up as the number of barrels produced increases, and falls as it drops.

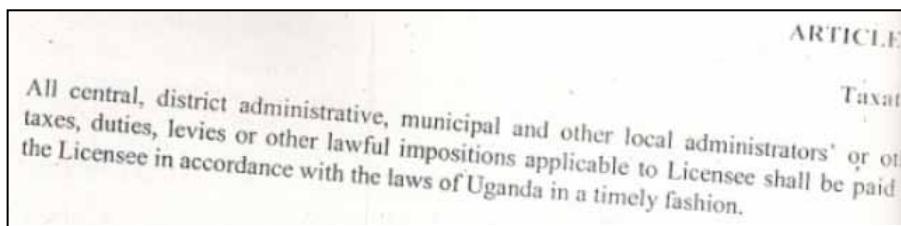
- It is common for PSAs to specify that the profit oil be split according to a sliding scale, to ensure some level of return for the private companies while delivering an appropriate rent to the host government.



- However, it is very unusual for this split to be based purely on the level of production. This means that the profit sharing terms provide no check for excessive company profits at the expense of Uganda – for example at times of high oil prices. Even the International Monetary Fund, an institution predisposed to supporting corporate demands and processes of economic liberalisation, admits in a confidential report that this is a major flaw with the current PSAs. The contracts are based on the false assumption “that the profitability of the projects is only determined by the volume of production”.⁴ The opposite is in fact the case - fiscal structures based on company profits are better able to obtain greater shares of rent than those based purely on the quantity of oil produced.
- The revenues accruing to Uganda are further undermined by the contracts’ stipulations that the profit oil split is set incrementally, and only based on the level of “remaining oil production per day after the deduction of cost oil”.

‘Complexity naturally favours those with the most accounting resources, but also tends to favour the company over the government, as the company has a far greater knowledge base of the details of its business. Conversely, it makes the operations largely inaccessible to scrutiny by civil society.’

ARTICLE 14 – TAXATION



The oil companies’ profits are apparently subject to corporation tax at the standard Ugandan rate. The comparison table describes this as 30%, although it is subject to change. The initial PSA for Block 3 referred to a 35% tax rate, although this was embedded in the profit oil split, meaning that in reality the company’s profits were not actually taxed at all.

SUMMARISING FISCAL TERMS

Whereas a royalty is a simple concept and is easy to calculate (if the rate of production and oil price are known), the calculation of taxes on profit (and of the sharing of profit oil) necessarily depends on the definition of profits – including such factors as how assets are depreciated, which costs are allowable and disallowable, the treatment of financing costs (such as bank interest) and so on.

Complexity naturally favours those with the most accounting resources, but also tends to favour the company over the government, as the company has a far greater knowledge base of the details of its business. Conversely, it makes the operations largely inaccessible to scrutiny by civil society.



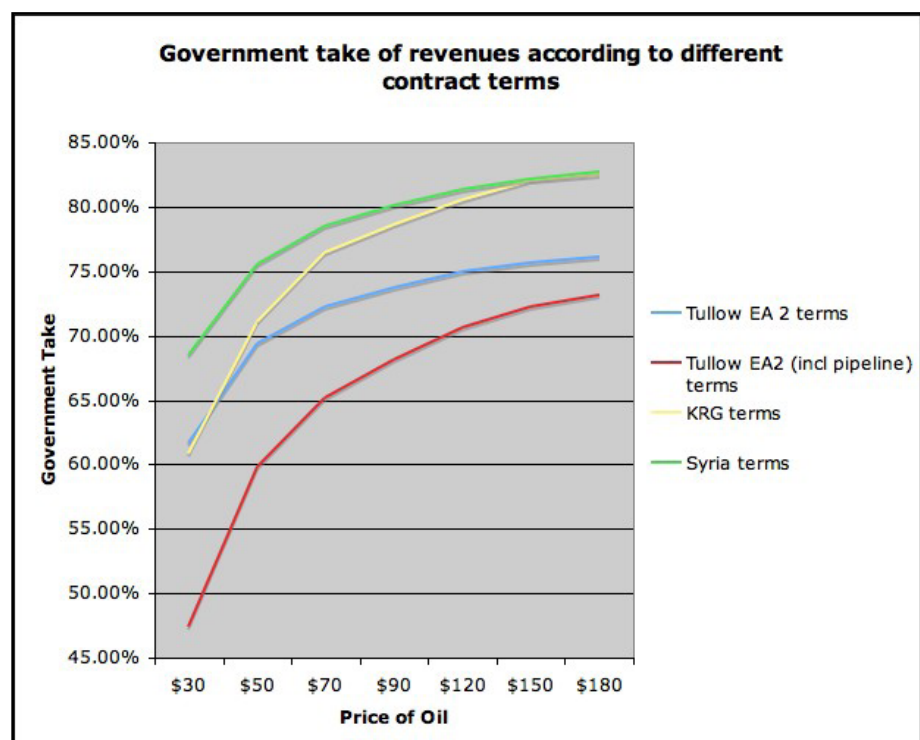
‘Heritage managed to secure a significantly better deal in Uganda than in Kurdistan, despite the fact that the Kurdistan Regional Government is not a recognised state, does not have the legal authority to negotiate, is locked in a lengthy battle with the central government over who has authority regarding oil matters and remains under military occupation by a foreign army with continued high levels of internal conflict.’

A. State Revenue – Exaggerated?

Statements by both Ugandan government spokespeople and oil company staff have repeatedly referred to total government take exceeding 80% of total revenues. However, the Loose Minute from Permanent Secretary Kabagambe – Kaliisa from September 2004 provides lower figures. The Minute was written to report on the conclusion of renegotiations covering Block 3/3A, and includes an estimate on total revenues to accrue to the government for Blocks 1, 2 and 3A.

The government models cover two different scenarios – one a field of 800 million barrels and the other of 1500 million barrels. Government take for the smaller field ranges from 67.5% for Block 2 to 69.5% for Block 3. The larger field would yield revenues of 72.1% to 74.2%. Although there have been significant oil discoveries since 2004, currently none of the blocks are expected to be contain more than 1500 million barrels. An analyst report produced by Credit Suisse on Heritage Oil provides an estimate of “government take rising from 55% at \$30 oil to 67% at \$70 oil, based on a minimum 600mboe reserves scenario”.

PLATFORM’s assessment provides highly varying figures for government take, depending on the price of oil, size of fields, development costs and other factors. Lower oil prices, smaller fields and higher development costs lead to the government receiving a lower proportion of revenues. Current plans for construction of a pipeline to export crude would also significantly reduce the proportion of revenue from oil sales coming to Uganda.





A possible middle-ground scenario based on oil prices predicted by the US Energy Information Administration, would result in government take of 70.7% (taking the pipeline into account) or just under 75% (no pipeline). However, in a context of low oil prices (\$30), the proportion of revenues going to the Ugandan government could crash to 47.4%. As the oil price rises, government take rises, before reaching a plateau of around 73% (incorporating the pipeline) or 76% (ignoring the pipeline).

Government take could be boosted to 77.3% (including the pipeline) or 79.5% (without pipeline) if the Ugandan government chooses to take up its right (set out in Article 11 State Participation of the PSA) for a 15% stake in a joint venture with the oil company. Uganda would not have to cover the costs of the participation – these would be covered by the oil companies. The government would need to take up this right within 120 days of receipt of the application for a Development License. Given the high profit levels predicted for the oil companies and comparatively low state take, not taking up this opportunity would represent a needless transfer in revenues from Uganda to the oil companies.

PLATFORM's model compared revenues from the model field under the fiscal terms set out in the PSA for Uganda's Block 2 to the terms of the PSA covering Heritage Oil's Miran prospect in Kurdistan, and to terms used in PSAs in Syria covering similarly sized fields. This comparison, as shown in Graph 1, reveals that the Kurdistan terms and the Syrian terms offer a greater government take of revenues. Even at low prices, the Syrian terms deliver a take that does not fall below 65%, while both plateau at over 80%.

The comparison with Iraqi Kurdistan is particularly striking, given that this is a contract signed by the same Heritage Oil that is operating in Uganda. Heritage managed to secure a significantly better deal in Uganda than in Kurdistan, despite the fact that the Kurdistan Regional Government is not a recognised state, does not have the legal authority to negotiate, is locked in a lengthy battle with the central government over who has authority regarding oil matters and remains under military occupation by a foreign army with continued high levels of internal conflict.

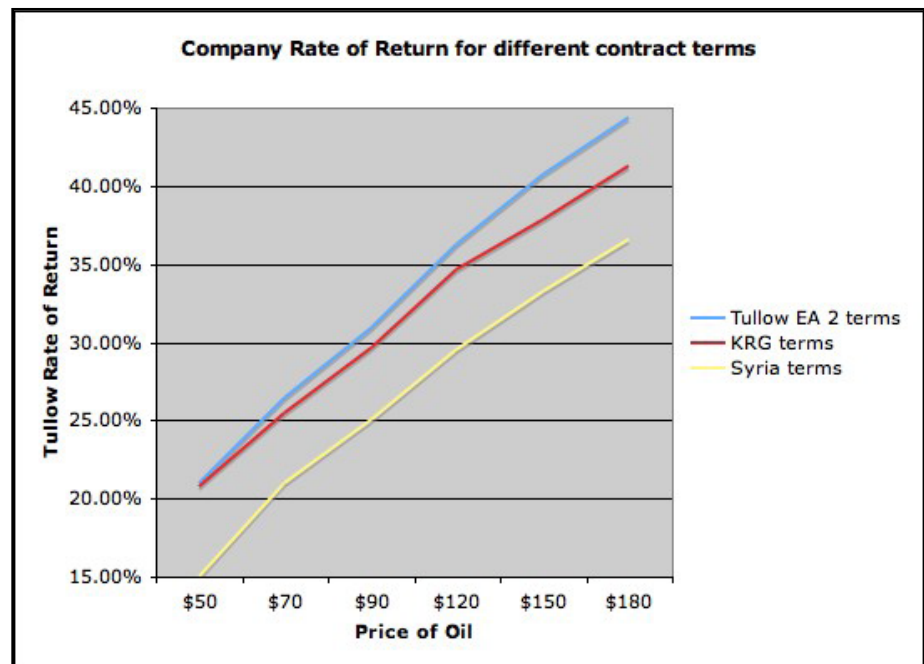
For all these reasons, a company operating there can demand very strong terms – a 'risk premium' - that they shouldn't be able to obtain in Uganda. While operating in Uganda could be described as risky, particularly on the border with Congo – the immediate dangers and risks are not equivalent with operations in Iraq.

'The calculations in this report reveal that Uganda's contracts are highly profitable for the participating oil companies. In the most likely scenarios, Tullow Oil could make a 30-35% return on its investment. This represents a very high profit level for the oil industry, even for risky projects.'



‘...a wildcat company exploring for oil should expect to make a reasonable return on its investment – but not to be able to sign permanent terms that guarantee excessive profits for 20 years. It is unfortunate that the Ugandan government chooses to emphasize the risks of the operations to justify the contracts it has signed, rather than renegotiate a fairer deal.’

B. Corporate Profits – Excessive?



When analysing the suitability of particular contracts, it is important to examine the benefits that will flow to both the government and the oil company extracting the reserves. A key measure of oil project profitability is the Internal Rate of Return (IRR) – this is what the oil company will assess to decide whether a project is financially worthwhile. In simplified terms, the rate of return describes the profit that the company will make off its investment.⁵

If this profit is greater than that which could be made by investing the money elsewhere, the project is worthwhile. The likely rate of return can be assessed to see whether the host government is receiving a fair deal, or whether the oil company has managed to sign terms that will lead to excessive profits. By way of comparison, oil companies generally consider any project that generates an IRR of more than a 12% to be a profitable venture. In riskier projects, companies will push for rates of return of 15-20%. Above 20% is widely considered to be a staggering profit rate.

The calculations in this report reveal that Uganda’s contracts are highly profitable for the participating oil companies. In the most likely scenarios, Tullow Oil could make a 30-35% return on its investment. This represents a very high profit level for the oil industry, even for risky projects. Even when stress testing profitability by modelling the least promising (and less likely) scenarios, such as a \$30 oil price, Tullow received a 12-14% IRR – a comfortable profit margin. Our assessment of corporate profits is backed up by those of Credit Suisse in their analyst report on Heritage Oil. Credit Suisse figures based on an oil price of \$30 and a (much smaller) reserve base of 350 million barrels indicate a 14% IRR.



Graph 2 compares the rate of return that the company is set to make from Uganda's contracts to the terms used in Kurdistan and in Syria. At any oil price, the companies will be making far greater profits in Uganda than they would on Syrian terms. At a low oil price, there is no real difference in profitability between Heritage's Kurdistan PSA and the Ugandan terms. However, as the oil price rises, companies operating in Uganda will see their profitability soar. The Kurdistan Regional Government (KRG) terms also lead to a climb in the corporate rate of return, but it is less steep than in Uganda and drops further away as the oil price rises.

'In Uganda's case, Tullow and Heritage clearly succeeded in avoiding price risk while capturing the potential benefits of high prices for themselves.'

In examining what Uganda's PSAs mean in terms of government take and corporate IRR, we can see that Uganda's loss in terms of government revenue will be the oil companies' gain.

The government has argued that it is unfair to compare Uganda to established oil producing countries. Uganda is only now joining the ranks of oil-exporting nations, while countries such as Syria and Iraq have exported for decades. However, the argument could also be made in reverse – is it fair to compare contracts signed by the KRG to those in Uganda, given that the KRG has no legal authority to sign oil contracts, all contracts signed have been declared invalid by the central government, the country remains under foreign occupation at civil war with major parts of the country inaccessible to government official or foreign oil workers. In comparison, Uganda has a sovereign recognised government with comparably higher levels of stability and investor rights. Syria on the other hand is subject to sanctions from the USA, the world's foremost economy. In other words, operating in an established oil producer does not mean that an oil development will be a success. Foreign investors will consider the risks of placing capital in Iraq, Syria and Uganda comparable. Furthermore, a wildcat company exploring for oil should expect to make a reasonable return on its investment – but not to be able to sign permanent terms that guarantee excessive profits for 20 years. It is unfortunate that the Ugandan government chooses to emphasize the risks of the operations to justify the contracts it has signed, rather than renegotiate a fairer deal.

C. High oil prices – Uganda losing out?

Graph 2 also shows that Uganda's contracts fail to capture an increased portion of rent as the oil price rises. This is a major flaw, especially in light of the high prices we have seen in recent years and associated revenues. As oil prices rose through the 2000s, there was recognition amongst producer governments that the state has a duty to its citizens to capture the rent from higher prices and that the private companies do not have a right to excessive profit-taking.

At a very low oil price of \$30 per barrel, Tullow will still make a strong return on its investment of almost 13%. However, at this price, the state is only receiving 61.6% of total revenues. This means that most of the price



‘Effectively the people of Uganda carry the risks on behalf of the foreign oil companies.’

risk is held by the Ugandan state rather than Tullow, i.e. Uganda carries the ‘downside’ that comes with low prices. Uganda will receive less than 75% of total revenues unless the average oil price remains above \$122 per barrel throughout production. The current price is significantly lower, at just over \$75.

However, the uncertainties in an investment comprise not just ‘downside’ – the risk that things go worse than planned – but also ‘upside’: the chance that things in fact go better.

Yet if the oil prices rise, it is Tullow, not Uganda, which captures the ‘upside’ – the chance of ever-higher profits. At \$70 Tullow makes a rate of return of 26.5%, at \$120 it is 36.3% and at \$180 the company makes 44.4%. The company’s profits rise at a steady gradient with increased prices. Meanwhile, Uganda – which carried the risk of downside – fails to increase its proportion of total revenues. Instead, as prices rise, the state’s take plateaus at just over 75%. In other words, Tullow can continue to take one quarter of revenues, whether the oil price is \$100 or \$250 – accruing enormous profits.

The aims of an oil company in negotiations on economic terms are to maximize upside, while minimizing downside. As Thomas Wälde (1996: 203) writes:

“Companies will try to obtain a flexible regime, but flexible only with respect to downside developments. Rare the financial analysis presented to the government team which does not use a ‘marginal’ base case and rare the tax package proposed which will not ‘just’ allow the development of a marginal project. The psychology of negotiators, particularly in an organisation, will tend to strive for a bargaining victory advertised to the corporate home front, and such bargain victories will rarely be famous for ‘upside flexibility’, i.e. for increasing the government share when the project turns out to be a big success.”

In Uganda’s case, Tullow and Heritage clearly succeeded in avoiding price risk while capturing the potential benefits of high prices for themselves.

A report produced by the Norwegian Agency for Development Co-operation (NORAD) in 2008 warned the Ugandan government that its model PSA:

“...does not provide for the Government to capture economic rent as a consequence of higher prices, cannot be regarded as being in accordance with the interests of the host country. The enormous increase in oil prices during the last 5 years have fully demonstrated the need for production sharing models that adequately protect the interests of the host country by securing the economic rent for the country. By economic rent is meant the profits of an investment that remain after deducting that income for the oil company which



corresponds to return necessary to a tract investment to the project in the first place.

“The economic rent should be for the benefit of the host nation owning the petroleum resources, and not the oil companies, which should only be secured the fair return on their investments. We are not aware of the PSA terms that were applied for the latest license award in Block 4B. It is in our view unfortunate, however, if the model PSA terms were applied also for that license, and not a modern production sharing model protecting the economic rate rent for the state.”⁶

Significantly, Reuben Kashambuzi, Uganda’s Commissioner at the Petroleum Exploration and Production Department, accepts in the same report that the existing PSAs damage Uganda’s national interest:

“We agree that the PSAs were not structured to take advantage of runaway oil prices being experienced worldwide today. Several attempts [to renegotiate] have not succeeded because of the perception that Uganda’s PSAs are very tough.”⁷

This supposed “perception that Uganda’s PSAs are very tough” has been fed by key people in government and particularly the Ministry of Energy through statements exaggerating the benefits Uganda will derive from the oil in order to justify secrecy and breed complacency. This political strategy – one that is intimately linked to the imperatives of the 2011 election and the need for the government to appear to be handling the oil issue successfully – is a classic example of short-term political horizons determining the long-term future of the country.

D. Risks – dumped on Uganda?

Apart from price risk, there is also the risk that something might not go according to plan – that costs increase or that management or technical failures mean that the project falls behind schedule. By examining the revenues of the project at different costings, we can determine how this risk is shared between the different parties.

By comparing a low cost scenario of \$1,735 million invested with a high cost scenario of \$4,545 million, we discover that as the costs increase, the government will lose a greater sum of money. The state’s discounted revenues (net present value) fall by \$500 million, while Tullow’s fall by only \$300 million. If non-discounted, Tullow’s total cashflow fall by \$700 million, but the state loses \$2.1 billion.

Although both are carrying some of the risk, the state stands to lose a greater sum of money than the oil company. This is despite the fact that project risk is something the company should be responsible for, given that it has been brought in with the technical expertise etc, and government has little direct say over spending.

‘By contractually granting the companies the right to develop this pipeline prior to government consideration or assessments (or any impact assessment on the part of the companies for that matter), the Ugandan government has signed away its ability to make an informed decision on whether an export pipeline is in Uganda’s best interests.’

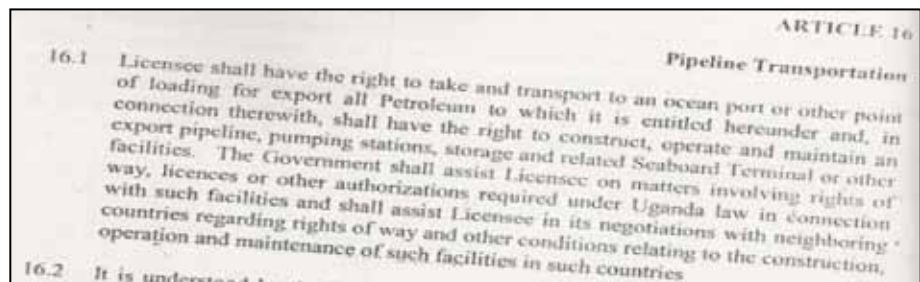


‘The companies exploring for oil have consistently used the apparent need for a pipeline to justify their excessively favourable terms. They have argued that because Uganda is a landlocked country, they are compelled to invest in oil transportation infrastructure and that this will affect their margins. However, given that the contract guarantees “a reasonable return” (i.e. strong profits) for the operators, this argument serves to distract from the fact that the pipeline represents another source of profit generation for oil companies operating in Uganda.’

The terms of the PSAs largely protect the companies from price risk and project risk, with guaranteed profits. Furthermore, the arbitration and stabilization clauses (Article 26 and Article 33) in the contracts protect corporate profits from changes in the law and signing of international treaties. Thus, Uganda is constrained in its ability to legislate or regulate, or to manage its economy. Meanwhile, citizens will not have the benefit or protection of international human rights or environmental protection.

Effectively the people of Uganda carry the risks on behalf of the foreign oil companies.

3) PIPELINES



This article gives the companies the right to construct an export pipeline through Uganda and Kenya, to bring their crude to an ocean port from where it can be collected by tanker.

- In examining environmental and social impact assessments (ESIAs), state environment ministries need to run a series of checks and comparisons prior to granting approval.
- Amongst other things, accepted good practice is to compare the benefits of the proposal with a “no-build” option. By contractually granting the companies the right to develop this pipeline prior to government consideration or assessments (or any impact assessment on the part of the companies for that matter), the Ugandan government has signed away its ability to make an informed decision on whether an export pipeline is in Uganda’s best interests.
- Furthermore, the rights and responsibilities laid out in this section are one-sided. While the contract explicitly states the oil companies’ rights to construct a pipeline and the government’s obligation to support such a plan, it does not include the opposite responsibilities – i.e. the contract does not state that the oil companies will conduct adequate impact assessments or strategic environmental plans or construct the pipeline to certain standards. Nor does it include a contractual right for the Ugandan government to investigate and oversee proposals prior to approval.
- Complex issues and risks associated with the pipeline that were raised by Tullow during a 2007 analyst visit included rights of way, trenching, pipeline coating, insulation, heating, tough terrain



including swamps, canyons, mountains and towns.⁸ Other major issues that the Ugandan government might want to consider are who takes responsibility for pipeline “security” and the impact of the route passing through nature reserves.

(b) the transportation tariff charged, to the extent that the Parties hereto are able to determine the same, shall be set at a level at which the Pipeline Company will cover the costs of constructing, financing, operating and maintaining the export pipeline and related facilities together with a reasonable return thereon; such return will be determined having regard to the risks assumed by shareholders of the Pipeline Company in outlaying the funds for the construction, operation and maintenance of such facilities and the cost of borrowing such funds as are required; and

Thus a pipeline tariff will be established for carrying crude so that the pipeline company can cover its costs and make “a reasonable return thereon [...] having regard to the risks assumed by the Shareholders of the Pipeline Company”.

- However, the contract leaves open both what level this “reasonable return” will be at and how and by who it will be established. Given the very high projected returns of 20-34% for the oil companies developing the fields along Lake Albert, there is a risk that the oil companies constructing the pipeline will aim for a similar return.
- The companies exploring for oil have consistently used the apparent need for a pipeline to justify their excessively favourable terms. They have argued that because Uganda is a landlocked country, they are compelled to invest in oil transportation infrastructure and that this will affect their margins. However, given that the contract guarantees “a reasonable return” (i.e. strong profits) for the operators, this argument serves to distract from the fact that the pipeline represents another source of profit generation for oil companies operating in Uganda.
- Furthermore, the fiscal analysis above indicates that the pipeline will reduce the proportion of oil revenues received by the Ugandan government, increasing the seriousness of the issue.

‘More dangerously, if the companies want to, gas “may be flared with the consent of the Government, which consent shall not be unreasonably withheld or delayed”. Gas flaring has been recognised as a human rights abuse that leads to severe health problems, environmental degradation, local toxic rain, as well as high levels of carbon emissions. In Nigeria, the government has struggled long and hard to compel Shell and other international oil companies to stop gas flaring, with the companies ignoring repeated court orders.’

4) NATURAL GAS & FLARING

ARTICLE 19
Natural Gas
19.1 Licensee shall have the right to use Associated Gas for Petroleum Operations, including, but not limited to, reinjection for pressure maintenance, and improving the recovery of Petroleum, power generation and recycling operations. The quantities of Associated Gas used in this way shall not be subjected to any tax, fee or levy of any kind.

“Associated gas” is natural gas which is extracted together with crude oil,



‘...if the companies want to, gas “may be flared with the consent of the Government, which consent shall not be unreasonably withheld or delayed”.’

from a primarily oil field. “Non-associated gas” is natural gas extracted from a primarily gas field.

- Control over what happens with any associated gas lies almost entirely with the companies. If there is associated gas, the company is entitled to use as much as it wants for free, for its own operations, before there is a decision on whether using the gas for other purposes is viable - thus reducing the likelihood that providing the gas to Ugandan communities will be considered.

19.3 Associated Gas which is not used in Petroleum Operations, and the processing and utilisation of which, in the reasonable opinion of Licensee is not economical, shall be returned to the subsurface structure, or may be flared with the consent of the Government, which consent shall not be unreasonably withheld or delayed. In the event that Licensee chooses to process and utilize the gas...

Furthermore, it is up to the companies to decide on whether processing and utilising associated gas is economical or not.

- The only guidance on how this decision is made is meaningless – it must be in the “reasonable opinion of the Licensee”.
- More dangerously, if the companies want to, gas “may be flared with the consent of the Government, which consent shall not be unreasonably withheld or delayed”. Gas flaring has been recognised as a human rights abuse that leads to severe health problems, environmental degradation, local toxic rain, as well as high levels of carbon emissions. In Nigeria, the government has struggled long and hard to compel Shell and other international oil companies to stop gas flaring, with the companies ignoring repeated court orders.
- Given the extremely damaging impacts of gas flaring elsewhere, the government’s consent to gas flaring should be determined by the likely impacts on local and wider communities and the environment, and not be limited to “consent not unreasonably withheld or delayed”.
- Currently, while section 31 of Uganda’s Petroleum (Exploration and Production) Act prohibits wasteful or environmentally damaging oil field practices, subsection (2) and (3) empower the holder of a petroleum exploitation license (the licensee) to flare natural gas.⁹ If the Ugandan government recognises that gas flaring is a dangerous and polluting practice and passes a law banning it, Uganda will need to compensate the oil companies accordingly, or go to arbitration in London.



5) TRAINING & JOBS

Training and Employ
 21.1 Licensee agrees to train and employ suitably qualified Ugandan citizens in Petroleum Operations and, following the commencement of Commercial Production, to undertake the schooling and training of Ugandan citizens for positions, including administrative and executive management positions. Licensee will also require its Sublicensees to do the same. Licensee undertake gradually replace its expatriate staff with suitably qualified and experienced Ugandan citizens as are then available but, if the Licensee satisfies the Advisory Committee that no suitably qualified and experienced Ugandan citizens are available, the Licensee may employ expatriate staff.

This sets out a responsibility for the oil companies to train Ugandan citizens to gradually replace expatriate staff and to train government personnel in oil operations.

- In many oil producing countries, contracts will set out strict percentage targets for local as opposed to expatriate employment, specifying necessary quotas for unskilled, semi-skilled and skilled jobs. However, Uganda's contracts set no specific timetable or quota targets, merely stating "the Licensee will gradually replace its expatriate staff" (emphasis added).
- It appears that the government and the companies have created unrealistic expectations around the employment opportunities that will follow from oil extraction in Uganda.¹⁰ While the oil exploration and production industry is capital intensive, it employs proportionately far lower workers than almost every other industry. While a number of unskilled workers will be needed during the development stages to construct roads, buildings and other infrastructure, these will mostly be short-term, insecure and low-paid positions.

21.3 Licensee shall deposit with government, or its Nominee, on the Effective Date and each anniversary of the Effective Date thereafter, the following amounts for training of Government personnel selected by the Government and other associated costs for each twelve (12) Calendar Months period.

First Exploration Period	US \$ 75,000 per 12 months.
Second Exploration Period	US \$ 75,000 per 12 months.
Third Exploration Period	US \$ 75,000 per 12 months.
Following the grant of a petroleum production license	US \$ 200,000 per 12 months.

21.4 Subject to the provisions of...

The contract specifies lump sums of \$50,000-\$200,000 per year to be deposited with the government to cover the training of government personnel.

'While the oil exploration and production industry is capital intensive, it employs proportionately far lower workers than almost every other industry. While a number of unskilled workers will be needed during the development stages to construct roads, buildings and other infrastructure, these will mostly be short-term, insecure and low-paid positions.'



‘The environmental impacts of oil and gas extraction are particularly serious along Lake Albert, as this “is the most species-rich eco-region for vertebrates and one of the most biodiverse areas on the African continent.”’

- These amounts are not only relatively small, but will also ultimately be covered primarily by the government, as the company can count training costs as an expense to be reimbursed with ‘cost oil’.
- According to the August 2008 Norad report, “no long-term training within oil companies or petroleum authorities or other countries have been reported. We raise the question whether the obligations of the oil companies having signed PSAs have fulfilled their training and employment obligations under the PSAs. It should be explored and followed up whether such on-the-job-training can be established to a larger extent, since it is an important competence building measure.”¹¹

6) DAMAGING THE ENVIRONMENT

25.13 The Licensee shall ensure that:

(a) Petroleum Operations are carried out in an environmentally acceptable and safe manner consistent with good international industry practice and applicable laws and that such operations are properly monitored;

- The environmental impacts of oil and gas extraction are particularly serious along Lake Albert, as this “is the most species-rich eco-region for vertebrates and one of the most biodiverse areas on the African continent.” It has been independently identified as an ‘endemic bird area’ by Birdlife International, an ‘ecoregion’ by World Wildlife Fund and a ‘biodiversity hotspot’ by Conservation International. It harbours more endemic species than any other region in Africa. It is also home to 79 threatened terrestrial vertebrates according to IUCN Red Data book listings. As such it is one of the most important conservation eco-regions in Africa.”
- “Good international and industry practice” varies heavily and is largely meaningless, as oil company practice primarily depends on local levels of regulation (“applicable laws”). Where a lack of government oversight or enforcement has enabled oil companies to cut corners, they have generally done so, leading to environmental devastation in Ecuador¹³, Russia¹⁴ and the Niger Delta¹⁵. Greater levels of regulation in rich countries have tended to lead to higher standards, although even then environmental problems have occurred with consistent frequency, including tar sands pollution in Canada, pipeline ruptures in Alaska and the Exxon Valdez spill.
- According to Jenik Radon of Colombia University’s School of International & Public Affairs, “governments must take into account that companies prefer to pay relatively low noncompliance penalties rather than make investments in pollution control. So fines need to be high enough to act as a



deterrent, and restoration of polluted areas by companies should be mandatory. [...] Government must have objective standards for environmental protection and must not lower them in the hope of increasing profits. There is no reason why environmental standards should be lower in developing countries considering that oil and gas are in such high demand.”¹⁶

‘The lack of enforcement mechanisms written into the contract is all the more serious, given that according to the Uganda Wildlife Society, “Uganda’s legal framework related to oil and gas shows a number of lacunas that may create conditions similar to those in the Niger Delta.”’

25.16 If the Licensee fails to comply with any terms contained in this Article within a period determined by the Minister under any such terms, the Minister may, after giving the Licensee reasonable notice, take any action which may be necessary to ensure compliance with such term, and recover, immediately after having taken such action, all expenditure incurred in connection with such action from the Licensee together with such interest as may be determined in accordance with Section 1.4(c) of Annex C to this Agreement.

5.17 The Licensee shall take such

- However, Uganda’s PSAs carry few specific or enforceable safeguards. Furthermore, where the company causes environmental damage or fails to otherwise comply with these terms, the government’s sole resort is to “take action [...] to ensure compliance” and “recover [...] expenditure incurred in connection with such action”. This means that there are no fines at all for causing environmental destruction. Deterrent fines are widely recognized as crucial to preventing regular and large oil spills. A US academic study found that a fine increase from \$1 to \$2 per gallon for large spills decreased spillage by 50%.¹⁷ The 1990 Oil Pollution Act in the US laid out fines of up to \$1,000 per barrel discharged.¹⁸ That the contracts provide no basis for fines, while Uganda simultaneously lacks an effective regulatory regime for the oil industry, clearly represents worst practice.
- The lack of enforcement mechanisms written into the contract is all the more serious, given that according to the Uganda Wildlife Society, “Uganda’s legal framework related to oil and gas shows a number of lacunas that may create conditions similar to those in the Niger Delta. The weak institutional framework and lack of political will for environmental monitoring and enforcement are also a cause for concern with regards to oil and gas development in the Albertine Rift.”¹⁹
- Improving Ugandan environmental legislation now without renegotiating the contract will not lead to greater enforceability of environmental standards, as the Stabilisation Clause (see Section 8 “Freezing Ugandan Law”) in Article 33 means that Uganda must compensate the oil companies for economically detrimental changes. As it is, current government capacity to oversee existing standards appears very limited. The Norwegian consultants Arntzen de Besche stated that “the Ministry of Water and Environment demonstrated in our meeting no knowledge at all about the petroleum activities.”²⁰



‘Highly threatened wildlife have been hunted and killed by oil workers. This includes the last male reed buck, an antelope at risk of extinction in Kabwoya wildlife reserve by workers of Busitema Mining Services, a Tullow Oil contractor. Wildlife managers and local community members claim that oil workers had previously been killing other animals in Kabwoya wildlife reserve, which is one of the most ecologically rich areas in Africa.’

- Concerns by Ugandan NGOs as to the challenge of “how to ensure that oil companies are held accountable when they damage the environment, and are made to clean up the development areas after completion of their contracts”²¹ are thus well founded.
- The need to clean up after completion of contracts (reinstatement) appears to be very far down the list of priorities for the oil companies. In Heritage Oil’s “Prospectus” upon listing on the London Stock Exchange, the company referred to the “risk” that “Any obligation to decommission a production facility may involve a substantial expenditure. These decommissioning costs are necessarily incurred at a time when the related production facilities are no longer generating revenue and no provisioning has been made in the Group’s accounts for such future decommissioning costs. It is intended that the decommissioning costs, when they arise, will be borne by the Group out of production revenue. There can, however, be no assurance that the production revenue will be sufficient to meet these decommissioning costs as and when they arise.”²²
- In other words, the company is choosing not to set aside any money to “decommission” and reinstate the environment, despite recognizing that it could be “a substantial expenditure”.

There are already significant concerns that the oil companies are not complying with good practice, as:

- The companies have not conducted a Strategic Environmental Assessment of the likely impacts.
- The companies are conducting explorative drilling within Murchison Falls National Park, a crucial site of biodiversity
- Elephant tracking by the Wildlife Conservation Society (WCS) showed that elephants made sudden and significant movements from the area during very noisy operations including construction, conductor pipe compaction and rig assembly, remained away during drilling and did not return until five months after it ended. Causation is of course virtually impossible to determine in such circumstances, but the WCS is investigating further.²³
- Ernst & Young’s audit report found poor waste management at Nzizi-2 and Mputa-2, the late restoration of the Murram site in Kabwoya and the Nzizi-1 well-site. The auditors warned that: “Environmental assessment needs ongoing attention as any delayed remedial action may cause extensive damage. The licensee should take appropriate remedial measures within a reasonable period and repair as much as is reasonably possible any damage to the environment so caused.” Rather than engaging with the concerns raised, Tullow rejected them, arguing that the auditor did not constitute a qualified environment specialist.²⁴
- Highly threatened wildlife have been hunted and killed by oil workers. This includes the last male reed buck, an antelope at risk of extinction in Kabwoya wildlife reserve by workers of Busitema



Mining Services, a Tullow Oil contractor. Wildlife managers and local community members claim that oil workers had previously been killing other animals in Kabwoya wildlife reserve, which is one of the most ecologically rich areas in Africa.²⁵

5.14 The Licensee shall, before carrying out any drilling, prepare and submit for review by the Minister an oil spill and fire contingency plan designed to achieve rapid and effective emergency response in the event of an oil spill or fire.

This article lays out that the oil companies will draft an oil spill and fire response plan, and submit it to the Minister.

- Accepted practice for response plans is to share a draft response plan with local communities and stakeholders as well as the government, before publishing the final plan. This is especially important, as emergency response plans affect the lives of those nearby. As of today, no draft oil spill and fire response plan has been publicized.

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7) UNDERMINING SOVEREIGNTY – RESOLUTION OF CONFLICTS

ARTICLE 26

Arbitration

Any dispute arising under the Agreement which cannot be settled amicably within sixty (60) days, shall be referred to Arbitration in accordance with the United Nations Commission for International Trade Law (UNCITRAL) Arbitration Rules. The arbitration shall be conducted by three (3) arbitrators appointed in accordance with the said Rules. The said arbitration shall take place in London, England. Judgement on the award rendered may be entered in any court having jurisdiction or application may be made in such court for a judicial acceptance of the award and an order of enforcement, as the case may be. The Arbitration award shall be final and binding on the Parties to this Agreement.

Any matter in dispute between the Government and Licensee arising under paragraphs 5.4, 7.6, 10.3, 15.2 and 35.2 may, at the election of either of such parties by written notice to the other, be referred for determination by a sole expert to be appointed by agreement between the Government and Licensee. If the Government and Licensee fail to appoint the expert within sixty (60) days after receipt of such written notice, either of such parties may have such expert appointed by the then President of the Institute of Petroleum (London). If the

Disputes are referred to arbitration in London according to rules of UN Commission for International Trade. This means that a conflict between the Ugandan government and a private oil company operating on Ugandan soil will be resolved not in Ugandan courts, but by an international investment tribunal. Moving the resolution of disputes to London undermines Ugandan sovereignty, treats the Ugandan state as



‘...the arbitration tribunal may rule that the law is only applicable in so far as it does not conflict with ‘international law’ (specifically investment law), and in case of conflict, the applicable law would be international law.’

a commercial entity of equal standing to a private corporation, removing concepts of public interest, responsibility or sovereignty.

The expert shall render his decision within (60) days after the date of this pointment, unless the Parties otherwise agree. In rendering his decision, the expert shall do so within the context of the provisions of this Agreement, the Act and the standards of Good Oilfield Practices. The decision of the expert shall be

The Institute of Petroleum (now renamed Energy Institute) is not a neutral body, but represents oil companies and oil professionals in Britain. Their new president (the individual appointed with selecting the expert to adjudicate) is James Smith, Chairman of Shell UK. Given Uganda’s desire to avoid a Nigerian oil experience, having a Shell executive selecting an “independent expert” is clearly wrong-headed. Furthermore, disqualifying an individual for reasons of “professional, personal or social interest or contract with the parties in dispute” is barely relevant when the Institute referred to represents a network of private companies and individuals working in those private companies, but not developing country nation-states.

There are no established “Standards of Good Oilfield Practices”, despite the capitalization in Uganda’s PSAs. The expert is to render his decision within the context of such “Standards” – is this referring to the standards of poverty in the Niger Delta, violence in Colombia, pollution of Exxon Valdez in Alaska or corruption in Azerbaijan?

Even though according to Article 33.1 “this agreement shall be governed by, interpreted and construed in accordance with the laws of Uganda,” the arbitration tribunal may rule that the law is only applicable in so far as it does not conflict with ‘international law’ (specifically investment law), and in case of conflict, the applicable law would be international law.²⁶

Arbitration was used effectively by French company Total to override regulation of its development of the Kharyaga field in Siberia, under a PSA (Russia’s third) signed in 1995. That PSA specified that the development required regulatory approval of its budgets and development plans – a common provision in many contracts. In December 2003, the regional and federal governments did not approve Total’s expenditure budget for the previous two years, objecting to the inflation of costs on the project. The regional governor warned:

“The state should control investment and the state should know exactly how much and where investments have been made. I am against investments planned in order to avoid taxes.” Total took the case to the Stockholm Arbitration Court. Although Total later admitted that some of its costs were indeed inflated, eventually the Russian authorities backed down in August 2005, and approved the two disputed budgets, in exchange for Total dropping the arbitration case.²⁷



8) FREEZING UGANDAN LAW - STABILISATION CLAUSES

33.2 If, following the Effective Date, there is any change, or series of changes, in the laws or regulations of Uganda which materially reduces the economic benefits derived or to be derived by Licensee hereunder, Licensee may notify the Government accordingly and thereafter the Parties shall meet to negotiate in good faith and agree upon, the necessary modifications to this Agreement to restore Licensee to substantially the same overall economic position as prevailed hereunder prior to such change(s). In the event that the Parties are unable to agree that Licensee's economic benefits have been materially affected, and/or are unable to agree on the modifications required to restore Licensee to the same economic position as prevailed prior to such change, within ninety (90) days of the receipt of the notice referred to hereinabove, then either Party may refer the matter for determination pursuant to paragraph 26.1

'...far from remaining open to potential renegotiations, companies aim to reduce political risk by contractually tying the hands of the government as firmly as they can. This is investment colonialism at its most extreme.'

This paragraph constitutes a stabilisation clause – if Uganda develops new and improved regulations that increase costs for the oil companies, the government must cover these costs.

Such a stabilisation clause reduces Uganda's legislative sovereignty. If Uganda changes its environmental regulations, laws governing workers' rights or any other standards that reduce the economic benefit to the oil companies, these must be compensated. This stands even if the companies have been profiting from overly low levels of regulation or high pollution levels.

There is increasing recognition that stabilisation clauses are detrimental to protection of democracy, environment, human rights and workers rights, and are an obstacle to development. Amnesty International has argued that stabilisation clauses like that covering the Baku-Ceyhan pipeline are likely to create a "chilling effect" on government's ability and intention to legislate to protect human rights and the environment.²⁸

Stabilisation clauses effectively immunize an investor from future changes in both fiscal terms and even legislation. To an investor such changes constitute political risks – to a state they constitute exercise of its sovereignty.

According to oil analyst Greg Muttitt: "The use of the term 'political risks' in infrastructure and extractive projects can commonly be characterized as a somewhat patronizing 'We don't trust the government not to change the rules'. By definition, this risk is carried by the foreign investor, rather than the state party. However, far from remaining open to potential renegotiations, companies aim to reduce political risk by contractually tying the hands of the government as firmly as they can. This is investment colonialism at its most extreme."²⁹



‘Keeping oil contracts secret enables increased environmental degradation, human rights abuses, conflict, displacement of communities, corruption and mismanagement.’

9) SECRECY

33.2 If, following the Effective Date, there is any change, or series of changes, in the laws or regulations of Uganda which materially reduces the economic benefits derived or to be derived by Licensee hereunder, Licensee may notify the Government accordingly and thereafter the Parties shall meet to negotiate in good faith and agree upon, the necessary modifications to this Agreement to restore Licensee to substantially the same overall economic position as prevailed hereunder prior to such change(s). In the event that the Parties are unable to agree that Licensee’s economic benefits have been materially affected, and/or are unable to agree on the modifications required to restore Licensee to the same economic position as prevailed prior to such change, within ninety (90) days of the receipt of the notice referred to hereinabove, then either Party may refer the matter for determination pursuant to paragraph 26.1

Uganda currently has five PSAs, covering much of the Western border with Congo and the Northern border with Sudan. None of these were made public by the government or the companies, despite repeated requests to the relevant government departments by various actors.

- Until PLATFORM published the terms in November, the most accurate public descriptions of the fiscal terms contained within the contracts were in Equity Analyst Reports produced by London-based banks for other investors, some of which are available online.³⁰
- In August 2009, Engineer Hillary Onek, the Energy and Mineral Development Minister, said “that the agreement the government signed with Tullow Oil provides for confidentiality.” He stated that “the government risks being sued if it publicized the document.”³¹ Even members of the Parliamentary Natural Resource Committee still vehemently deny they were shown the PSAs in June 2008. MP Beatrice Atim directly told a Ministry of Energy representative at an oil conference on September 10: “We have not seen the PSAs. [NRM] MPs lie and say ‘we were shown it’. But I can assure you we were not.”³²
- Transparency of contracts is widely recognised as a “a necessary element of any effort to promote the responsible management of natural resources for growth and economic development.” Those oil-producing countries blighted by the “resource curse” – Nigeria, Angola, Ecuador, Equatorial Guinea, Venezuela and many others - were almost always marked by a lack of transparency over the contracts covering extraction of oil resources, and a resulting lack of public debate and accountability. The handful of states where oil has had positive impacts on local ‘development’, such as Norway, have high levels of openness and transparency, with full contracts available for public examination.
- Keeping oil contracts secret enables increased environmental degradation, human rights abuses, conflict, displacement of communities, corruption and mismanagement.



- A recent report by Revenue Watch International argues that improved transparency would enable governments “to negotiate better deals, as the information asymmetry between governments and companies closes. In the shorter term, contract transparency will help government agencies responsible for managing and enforcing contracts, of which there are many, work in tandem. With contracts publicly available, government officials will have a strong incentive to stop negotiating bad deals, due to corruption, incompetence, or otherwise. Citizens will better understand the complex nature of extractive agreements if they are out in the open and explained by the contract parties... States and companies blame each other for the blanket secrecy that covers agreements; specific claims about trade secrets or commercially sensitive information are not typically supported in fact; and none of the major actors openly discusses issues of corruption, power dynamics or raw incompetence, all of which the disclosure of contracts has been known to expose.”³³
- Although some of Uganda’s contracts have now been published online and made available for public debate, there remains no government transparency over the contracts it signed or the renegotiations it has entered in recent years. Neither have the companies operating in Uganda committed to transparency over revenue flows – even the minimum standards set out by the UN-supported Extractive Industry Transparency Initiative (EITI).
- This avoidance of openness and accountability will prevent positive development outcomes while enabling corruption and environmental degradation on the part of the oil companies. Past experience indicates that without public debate, the “resource curse” is largely inevitable.

‘This avoidance of openness and accountability will prevent positive development outcomes while enabling corruption and environmental degradation on the part of the oil companies. Past experience indicates that without public debate, the “resource curse” is largely inevitable.’

10) OVERSIGHT & AUDITS

THE REPUBLIC OF UGANDA

(b) The Government shall make every reasonable effort to conduct audits in a manner, which will result in the minimum of inconvenience to Licensee. Licensee shall make every reasonable effort to co-operate with the Government and its statutory auditors or the independent auditors, as the case may be, will provide reasonable facilities and assistance. Subject to the provisions of paragraph 1.5(c) hereunder, only one audit may be carried out by the Government in respect of the accounts for any single Calendar Year.

- Limiting the Government to one audit per year reduces its ability to hold the companies in check, particularly as a first audit may throw up issues and queries that need further assessment.
- The importance of this provision became clear when Heritage Oil used it to avoid accountability to the government over financial issues.
- An Ernst & Young Review of Heritage Oil’s exploration activities



‘Military support for oil extraction operations by private companies has clearly already begun. Currently, a battalion of the elite Presidential Guard Brigade is responsible for Uganda oil region. This military capacity is to be bolstered through imminent construction of a new military base on ten square miles in the Hoima District. The site of the proposed base is currently occupied by a refugee camp, whose residents oppose eviction.’

between September 2004 and October 2006 was delivered to the Ugandan government in April 2009. The audit found that Heritage had overclaimed cost recoverable expenditure by \$586,511 and underpaid tax by \$1,724,130. Ernst & Young further criticised Heritage for not providing adequate budget information to the Government Advisory Committee and warned of the “risk of inflating costs and expenses, more especially costs incurred outside Uganda.”

- Heritage has already rejected suggestions of a special audit, by specifically citing Annex C, Article 1.5(b) stipulation of only one audit per year.³⁴

11) HUMAN RIGHTS ABUSES, CONFLICT & SECURITY

The contracts PLATFORM has obtained contain no clauses covering security provision. There is no public agreement setting out the relationship between the oil companies and the military or police forces. Thus it is unclear what promises and guarantees the Ugandan government has made to ensure security and what rights the oil companies have been awarded.

This leaves open critical questions, including:

Do oil company security or private military contractors have the right or authority to arrest, injure or kill those they perceive as a threat?

Do oil company security have the authority to deal with protest or opposition to oil extraction projects?

Do the contracts include indemnification of the company against liability for any human rights abuses arising?

Do military contractors have the right or authority to interact with foreign forces?

Has the Ugandan government promised to ensure security?

Is the Ugandan government financially liable if there is a breach in security?

Is the Ugandan government incentivised to prioritise security interests over the human rights of local populations?

- Military support for oil extraction operations by private companies has clearly already begun. Currently, a battalion of the elite Presidential Guard Brigade is responsible for Uganda oil region. This military capacity is to be bolstered through imminent construction of a new military base on ten square miles in the Hoima District. The site of the proposed base is currently occupied by a refugee camp, whose residents oppose eviction. Media reports have indicated that, the establishment of a new army base on the Ugandan side may compel Congo to carry out a similar action, raising tensions.
- On a national level, an Oil Wells Protection Unit (OWPU) drawn from various security organs, including ISO, ESO, the UPDF, police and prisons, has been formed. Apparently its mandate is



“to provide physical security for the oil and gas industry” and “conduct strategic intelligence activities in all areas where oil will be processed and marketed”.³⁵ However, the OWPU has no website and no clearly known structure or chain of command. Until the Petroleum Bill is passed, the OWPU has no statutory basis. In this context, the OWPU could easily be misused to repress opposition to oil extraction activities, further political gains by the government and commit human rights abuses without accountability.

- The past record of oil companies shows that they are able to operate in conflict zones – although with a devastating impact on local people. For example, operating in Colombia in the 1990s during the civil war, BP funded army units implicated in serious human rights abuses, which employed a US-designed counter-insurgency strategy of dirty war, known as “draining the fish tank”. Instead of fighting the guerrillas, the army and pro-government paramilitary death squads targeted civilians considered sympathisers.³⁶
- The oil companies operating in Uganda have themselves played an active role in conflicts on the African continent. Heritage Oil employed Executive Outcomes, composed primarily of white mercenaries previously in the apartheid South African Military, to drive UNITA rebels out of the Soyo region in north-western Angola where Heritage was extracting oil. Tony Buckingham, who remains the Director of Heritage, became a business partner in Executive Outcomes with South African Eeben Barlow. Executive Outcomes went on to spearhead Angolan military assaults onto UNITA-controlled oil areas.³⁷
- Concerns over the oil companies’ impacts on conflicts & human rights elsewhere appear to be well founded, given their activities since arrival in Uganda and neighbouring Congo. According to a statement by the United Nations Mission in Congo (Monuc) in 2007, Heritage Oil had donated speedboats to the FARDC (Congolese national army) in March of that year and had also been responsible for the delivery of 30 Land Rover jeeps to Bunia, which were then distributed to local commanders across the region.³⁸ The national army remains a fragile and controversial presence in Ituri, “seeking to assert central authority while also committing widespread human rights abuses, from routine ‘tracasserie’ (harassment) to corruption and sporadic violence. Cooperation between companies and soldiers – of any stripe – breeds suspicion and fear.”³⁹
- However, Heritage’s activities in the area have been more complex than merely providing support to a national army. Already in 2002, as the company signed a first memorandum of understanding with the DRC government, Heritage admitted to seeking consent to the deals in writing from the rebel leaders then in control of Ituri and North Kivu: the MLC (Mouvement de Libération du Congo) of Jean-Pierre Bemba, and the RCD-Kis/ML

‘The oil companies operating in Uganda have themselves played an active role in conflicts on the African continent. Heritage Oil employed Executive Outcomes, composed primarily of white mercenaries previously in the apartheid South African Military, to drive UNITA rebels out of the Soyo region in north-western Angola where Heritage was extracting oil.’



‘Even prior to oil production, worrying trends are already emerging: secrecy, cooperation with militias, the arming of security forces by companies, and clashes at borders and extraction sites. In this context, these tensions are likely to accelerate and escalate further once the oil is being pumped and enormous revenues are at stake.’

- of Mbusa Nyamwisi. Both groups had Ugandan troops at strategic locations on their territory.⁴⁰
- Also in August 2007, the Congolese government accused Heritage Oil of opening fire on its forces and “carrying out illegal exploration”.⁴¹ Throughout 2008 the Congo government claimed that “Tullow and Heritage Oil had breached the border on Lake Albert, with support from the Ugandan army, leading to eight Congolese fatalities”, according to the BBC.⁴²
- Even prior to oil production, worrying trends are already emerging: secrecy, cooperation with militias, the arming of security forces by companies, and clashes at borders and extraction sites. In this context, these tensions are likely to accelerate and escalate further once the oil is being pumped and enormous revenues are at stake.



PHOTO: BUSERUKA WATERFALL CUTS THROUGH THE ESCARPMENT / TAIMOUR LAY

Conclusion & Recommendations

Will Oil Benefit Uganda?

The oil contracts in Uganda do not provide enforceable protection standards regarding the environment or the human rights of Ugandan citizens, relying on the oil companies to operate reasonably and altruistically. Yet despite their promises of corporate responsibility, the oil companies' foremost legal responsibility is to maximize profits for their shareholders – other commitments can be sacrificed to achieve this. This is made explicit in Heritage's 2008 Prospectus to potential shareholders.⁴³ The failure of the contracts to protect Uganda is compounded in that national law and oil policies do not currently provide “enough specific and enforceable obligations to promote responsible regulation of [the oil & gas] sector, especially with regard to protection of the environment.”⁴⁴

While the government claims that it will present a “new oil law” to parliament imminently, there is as yet no sign of it. The signed contracts, including the “stabilization clause”, fatally undermine the efficacy of any new legislation. Current negotiations over development plans with the oil companies continue to place the cart before the horse.

Internationally, there is a wealth of evidence that most oil-dependent economies tend to show poorer economic development outcomes than those of countries without oil; the key determining factor as to whether positive or negative outcomes are achieved is “the type of pre-existing political, social and economic institutions available to manage oil wealth as it comes on-stream”⁴⁵. Thus if there is a lack of public sector capacity to develop the oil, this will almost certainly extend also to environmental and economic regulatory functions, negotiating contracts and monitoring and regulating performance – all crucial elements in obtaining any positive developmental, social and environmental outcome from investment.

In this context, it is clear that extracting the oil discovered in the Albertine Graben is highly unlikely to bring overall benefits in terms of economic development, let alone environmental protection or human rights to the region. The Ugandan government and companies have repeatedly criticised comparisons with Nigeria, Angola, Ecuador or other oil-producing countries in the global south, asking why the focus is on those countries with negative social & economic outcomes from oil. Instead Uganda's citizens should apparently wait to be transformed into Africa's new Norwegians. But the reality is that the political, economic and social context of Uganda is not that of Norway – and development outcomes will differ accordingly.

The honest reality is that extracting the millions of barrels of crude lying beneath Western Uganda is most likely to exacerbate poverty, distort the Ugandan economy, weaken other more labour-intensive sectors of the economy including agriculture⁴⁶, increase human rights violations, entrench the power of military forces, escalate tensions across the border

‘In this context, it is clear that extracting the oil discovered in the Albertine Graben is highly unlikely to bring overall benefits in terms of economic development, let alone environmental protection or human rights to the region.’

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with Congo, create new health problems for local communities, increase both intentional corruption and revenue mismanagement, reduce Uganda’s wildlife stocks and pollute the land, water and air.

Extracting the oil will not lead to a “win-win” situation – unless expectations of “winning” are limited to increased profits for the oil companies and local elites. Talk of a possible “win-win” situation contributes to building up a false and unrealizable hope, while distracting from the far more likely negative impacts.

As crude is being extracted from Lake Albert, the task at hand is to reduce the negative impacts of these operations. This involves both renegotiation of existing contracts, and ensuring that future contracts for new blocks and the model PSA used in talks with investors are changed to better protect Ugandan interests. The apparently watertight legal agreements are susceptible to change if there is the right amount of domestic and international political pressures. Such renegotiations have taken place in Bolivia, Kazakhstan, Ecuador and Nigeria.⁴⁷ In this context, this report makes the following recommendations:

- Urgent changes should be made to the contracts, legislation and regulatory regime covering oil, to achieve some level of environmental protection, to ensure accountability for military forces enforcing security, to protect a degree of Ugandan sovereignty, to minimize economic distortion through revenue flows, to capture a more appropriate share of the revenues and to re-apportion the economic risks.
- The terms of Uganda’s Production Sharing Agreements should be renegotiated, taking into account the above analysis of each clause, to reduce the likelihood that these contracts will undermine the economy, sovereignty, stability, environment and human rights of Uganda.
- Such a renegotiation must ensure that environmental protection is prioritized, with clear lines of accountability, high enough fines to act as deterrents against failures and pollution and enforced reinstatement of land and water to prior conditions.
- Economic terms of the oil contracts must be revised to ensure that Uganda benefits from ‘upside’ including high oil prices and does not carry disproportionate risks from increased costs. The Ugandan government should receive a greater and appropriate portion of economic rent; the oil companies should not make excessive profits at Uganda’s expense.
- Reducing the developmental impacts requires a systemic improvement in transparency on the part of the government and the companies, and an end to secrecy covering contracts, revenue

flows, negotiations and future plans. Further, full public debate and democratic involvement of Uganda's citizenry is crucial. There need to be clear practical lines of accountability for the government, in which local communities and citizens have a say and an impact.

- Minimising the negative impacts of sudden major revenues flows requires a public, thorough and long-term plan for oil revenues, in which the revenues do not merely enter the standard national budget.
- "Security" arrangements for all oil operations, including sites of extraction and any pipelines, must have the support and involvement of local communities. They must not be controlled by forces with a history of human rights abuses, whether national, militia or private military contractors.
- Negotiation of development plans with the oil companies must be put on hold until Uganda has enacted the legislation for a regulatory regime that protects rights, environment, health and safety.
- This report should be used by civil society advocates, journalists, members of the Parliamentary Natural Resources Committee and community groups to start an urgent campaign in which government and companies are asked critical questions and placed under well-informed pressure. The gap between 'opinion-formers' in Kampala, many of whom disingenuously claim to have seen and understood the contracts, and the Ugandans on the ground who will be most affected by oil exploration, needs to be closed and a renewed effort made to democratise debate and opposition.

'Negotiation of development plans with the oil companies must be put on hold until Uganda has enacted the legislation for a regulatory regime that protects rights, environment, health and safety.'



PHOTO: UGANDAN FISHING BOATS ON THE BEACH OF LAKE ALBERT NEAR KAISO-TONYA IN BLOCK 2 / TAIMOUR LAY

Production Sharing Agreements

The PRODUCTION SHARING AGREEMENT (PSA) is a complex contractual structure. In theory, the state has ultimate control over the oil, while a private company or consortium of companies extracts it under contract. In practice, however, the actions of the state are severely constrained by stipulations in the contract. In a PSA, the private company provides the capital investment, first in exploration, then drilling and the construction of infrastructure.

The first proportion of oil extracted is then allocated to the company, which uses oil sales to recoup its costs and capital investment – the oil used for this purpose is termed ‘cost oil’. There is usually a limit on what proportion of oil production in any year can count as cost oil. Once costs have been recovered, the remaining ‘profit oil’ is divided between state and company in agreed proportions. The company is usually taxed on its profit oil. There may also be a royalty payable on all oil produced.

Sometimes the state also participates as a commercial partner in the contract, operating in joint venture with foreign oil companies as part of the consortium – with either a concession or a PSA model. In this case, the state generally provides its percentage share of development investment and directly receives the same percentage share of profits.

An ingenious arrangement, PSAs shift the ownership of oil from companies to state, and invert the flow of payments between state and company. Whereas in a concession system, foreign companies have rights to the oil in the ground, and compensate host states for taking their resources (via royalties and taxes), a PSA leaves the oil legally in the hands of the state, while the foreign companies are compensated for their investment in oil production infrastructure and for the risks they have taken in doing so.

When first introduced in Indonesia in the 1960s, many in the oil industry were initially suspicious of Indonesia’s move. However, they soon realised that by setting the terms the right way, a PSA could deliver the same practical outcomes as a concession, with the advantage of relieving nationalist pressures within the country. In one of the standard textbooks on petroleum fiscal systems, industry consultant Daniel Johnston comments:

“At first [PSAs] and concessionary systems appear to be quite different. They have major symbolic and philosophical differences, but these serve more of a political function than anything else. The terminology is certainly distinct, but these systems are really not that different from a financial point of view.”

So, the financial and economic implications of PSAs may be the same as concessions, but they have clear political advantages – especially when contrasted with the 1970s nationalisations in the Middle East. Professor Thomas Wälde, an expert in oil law and policy at the University of Dundee, describes them as:

“A convenient marriage between the politically useful symbolism of the production-sharing contract (appearance of a service contract to the state company acting as master) and the material equivalence of this contract model with concession/licence regimes in all significant aspects...The government can be seen to be running the show - and the company can run it behind the camouflage of legal title symbolising the assertion of national sovereignty.”

Input Data

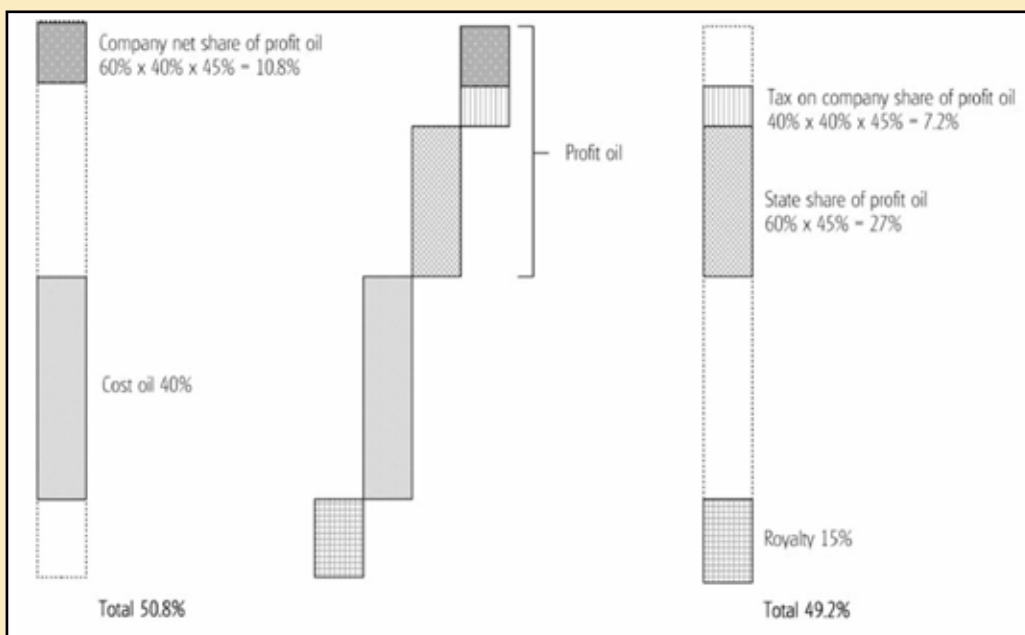
Due to the variation in terms between different contracts, we have based our models on the fiscal terms for Block 2, held 100% by Tullow.

If not stated otherwise, we are assuming a field size of 1,032 million barrels of recoverable oil, capital expenditure of \$2,295 billion, operating costs of \$2.5 per barrel and a discount rate of 12%. At this stage, with ongoing exploration activity, we will not know the exact size of Uganda's oil reserves. The precise figures are always changing and will only be known in retrospect, so our assumptions are based on Tullow Oil and Heritage Oil reports to their shareholders and stakeholders, and detailed analyst reports to investors. Following Credit Suisse, we have assumed export pipeline costs of \$2.1 billion and a tariff of \$7 per barrel. We have also tested our models with a variety of field sizes, projects & operating costs and discount rates.

Wherever there was an option or a doubt over terms or data, we have opted to make conservative assumptions – those which will lead to lower profits for the companies and higher revenues for the government. This means that our conclusions represent a best-case scenario for the Ugandan government, and a worst case scenario for the oil companies involved. This in part explains the lower government take and higher oil company profits predicted by Credit Suisse in their analysis.

Also, with frequent reports of new discoveries, there is little distinction and much confusion between “oil in place” (the total oil in the ground) and “recoverable oil” (the oil that can actually be extracted). Recoverable oil is generally between 30-37% of “oil in place”, although in certain difficult regions it drops to 12-16%.

Split in revenues from a hypothetical PSA



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