Uganda's contracts – a bad deal made worse

Preliminary analysis of Uganda's Production Sharing Agreements by PLATFORM

SUMMARY

- There is currently no transparency over Uganda's oil contracts, on the part of the Ugandan government or the foreign oil companies. This 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 and accountability, the "resource curse" is largely inevitable.
- The Production Sharing Agreements signed in Uganda do not represent the great deal publically claimed by the government. Internal figures modelled by the government indicate that the state will receive 67.5% - 74.2% of total revenue. A Credit Suisse analysis of Heritage Oil predicts government take of between 55% and 67%. PLATFORM's assessment indicates the government will received between 47.4% and 79.5% of revenues, depending on the price of oil, size of fields, development costs and other factors. The highest figures will only be achieved if the government takes up the possible 15% state participation. These figures are all below the 80+% regularly trumpeted by the government and the oil companies.
- The 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, and indicates excessive profit-taking at the expense of the host government. Even in the least promising (and less likely) scenarios, Tullow would received a 12-14% return – a comfortable profit margin.
- Compared to contracts in other countries, Uganda is receiving a worse deal. Modelling the same field under the terms of Heritage's contract in Iraqi Kurdistan (a more dangerous environment) indicates that the Kurdistan Regional Government will receive a greater proportion of revenues than Uganda, while Heritage will receive a higher rate of return in Uganda.
- Uganda's contracts fail to capture increased rent as the oil price rises. This is a major flaw, especially in light of the recent high oil prices. As prices rose through the 2000s, there was a 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. As the oil price rises, the oil companies make a higher and unlimited profit. However, the state take plateaus at under

80%. Thus the oil companies will take close to one quarter of oil revenues, whether the oil price is $70 or $200 – raking in enormous profits.

- Most of the risks lie with the Ugandan state, not the private companies. Price risk lies primarily with Uganda, with the private companies virtually guaranteed a profit even at low prices. While project risk (eg increased costs) are shared between both, Ugandan revenues will fall significantly further if the project runs over-budget.

CONTEXT

Oil in Uganda

Lake Albert in Uganda was considered an attractive oil prospecting region for a long time, especially given the natural oil seepage in the area. BP and other companies explored in the 1930s with the first well in 1938, but 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, Heritage Oil. Exploration Area 3 was licenced to Heritage in 1997, in the form of a Production Sharing Agreement (PSA). This was renegotiated in 2004 with Heritage and Energy Africa (now owned by Tullow). Another 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 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.

Exploration activity by Tullow and Heritage led to major discoveries across the Lake Albert basin from 2007 onwards. Kingfisher 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.

Oil Contracts in Uganda

Uganda licensed oil exploration and extraction through contracts known as Production Sharing Agreements (PSAs). See Appendix 2 for background on PSAs.

Existing PSAs in Uganda are:

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

None of these contracts have been made public. The government has claimed an obligation to commercial confidentiality. The oil companies have at points stated that the contracts are confidential, while at other times claiming that they have no problem with them being released. The government has repeatedly made claims of receiving 80% of total revenues from oil extraction and media articles have contained various references to the terms of the contracts.

However, until today, the actual content of the Production Sharing Agreements has remained a closely guarded secret. PLATFORM has obtained a copy of the Block 3A 2004 PSA between Uganda and Heritage, which includes a comparison with the terms of the PSAs covering Block 1 and Block 2. We have also sourced the Dominion Block 4B PSA, and a draft of the Tullow Block 2 PSA, which conversations with Tullow staff indicate has not been renegotiated since.
All documents are available linked from http://www.carbonweb.org

Terms of Contracts

Uganda's Production Sharing Agreements all have similar, but slightly varying fiscal terms. The terms for Block 2, held by Tullow Oil, are

- An incremental royalty from 5% - 12.5% for oil production of 0 - >7,500 barrels per day.
- Cost recovery limit of 60% of income
- No signature or other bonuses
- An incremental profit oil split ranging from 40% to 65% to the government for oil production of 0 - >40,000 barrels per day.
- Income Tax of 30%
- Possible state participation of 15%

With the terms available, PLATFORM has produced a quantitatively and qualitatively analysis of Uganda's Production Sharing Agreements, and compared the outcomes to those of contracts signed elsewhere. We have produced a fiscal model, based on Tullow's Block 2 field.
Our input data is contained in Appendix 2.

PLATFORM ANALYSIS

1. **Transparency**

Uganda currently has five Production Sharing Agreements, covering much of the Western border with Congo and the Northern border with Sudan. None of these are available online and despite repeated requests to the relevant government departments by various actors, none have been provided.

The terms have not been published in Uganda's newspapers. The most accurate public descriptions of the fiscal terms contained within the contracts are in Equity Analyst Reports produced by London-based banks for other investors, some of which are available online.[i]

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."[ii] 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.''[iii]

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 contributes to environmental degradation, human rights abuses, conflict, displacement of communities, corruption and mismanagement.

A recent report by Revenue Watch International argues improved transparency would mean that

“Over the long term, governments will be able 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.”[iv]

Although we have now placed some of Uganda’s contracts online and made them 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 Extractive Industry Transparency Initiative (EITI).

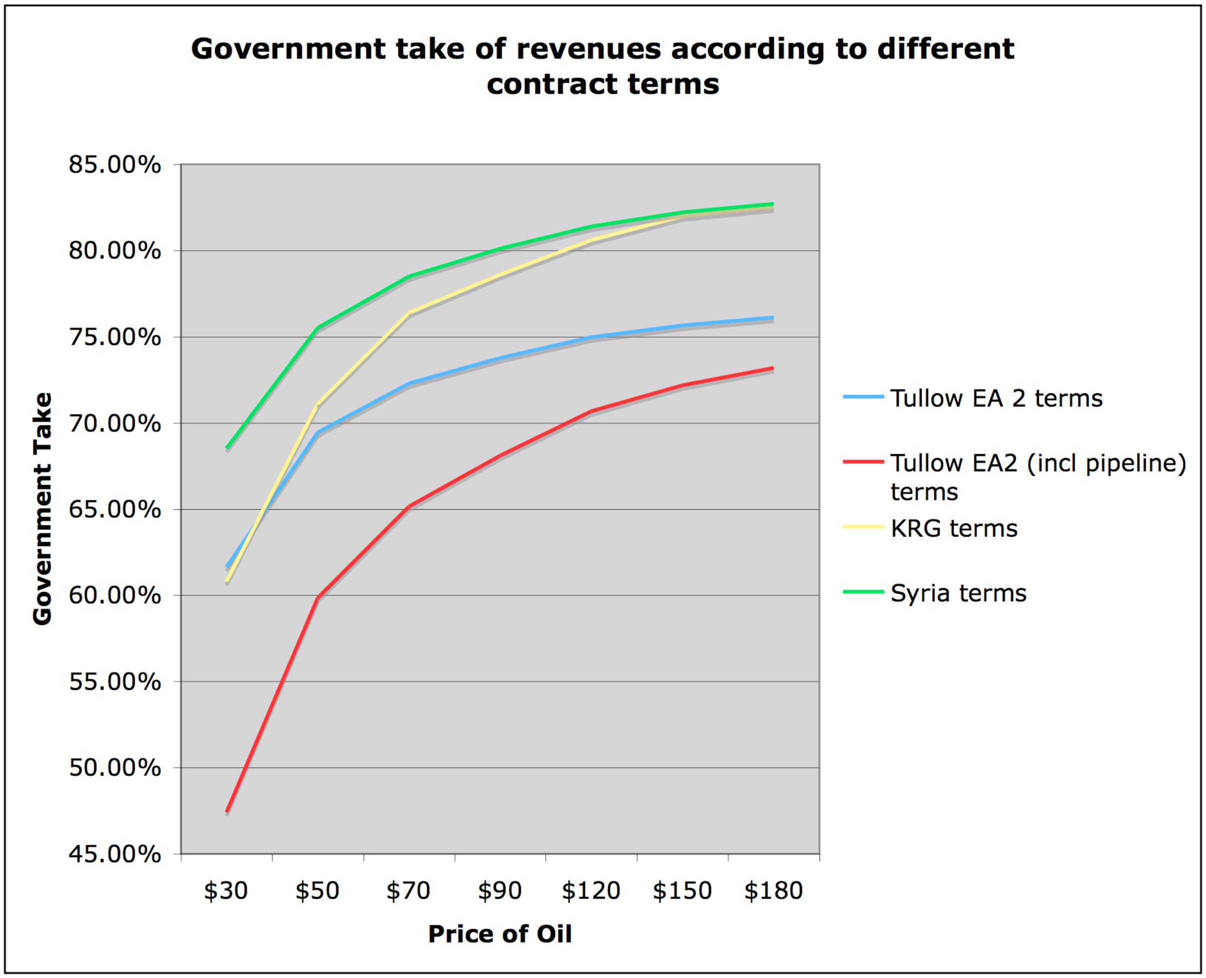
This avoidance of openness and accountability will prevent positive development outcomes while enabling corruption and environmental degradation on the part of the oil companies. Past experience indicates that without public debate, the “resource curse” is largely inevitable.

2. 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 2 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 600 mmboe 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 EIA 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 Tullow. 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 an inexplicable 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 similar sized fields. This comparison, as evidenced 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 do not fall below 65%, while both plateau at over 80%.

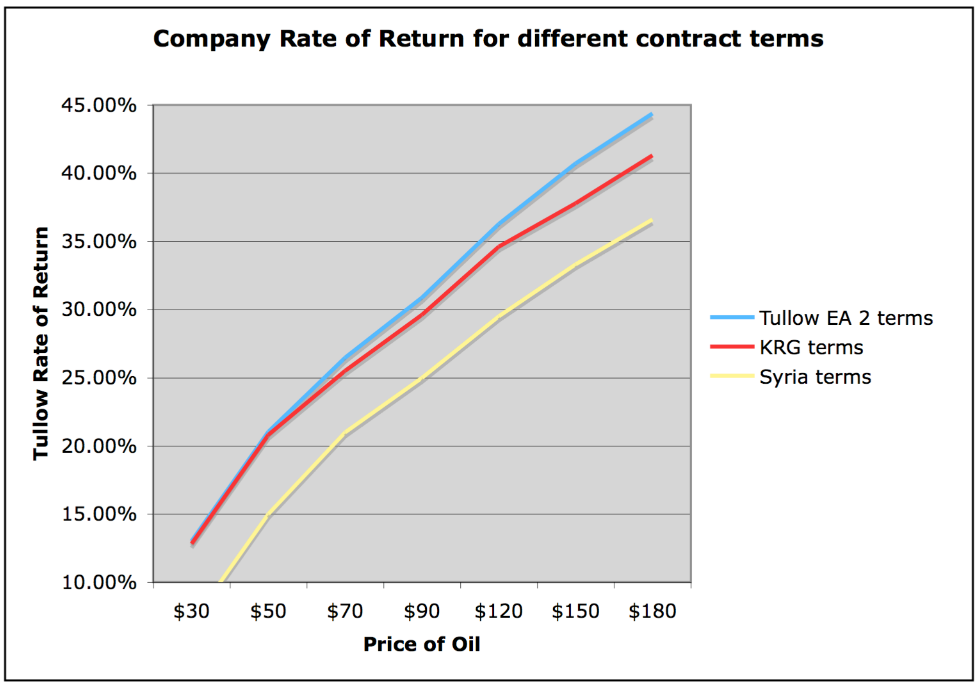
The comparison with Iraqi Kurdistan is particularly striking, given that this is a contract signed by the same Heritage Oil that is operating in Uganda. Heritage managed to secure a significantly better deal in Uganda than in Kurdistan, despite the fact that the Kurdistan Regional Government is not a 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, 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 get in Uganda. While operating in Uganda could be described as risky, particularly on the border with Congo – yet the immediate dangers and risks are not comparable with operating in Iraq.

3. 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 worth its while. In simplified terms, the rate of return describes the profit that the company will make off its investment. [v]

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 which 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.

Our calculations 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 on our model field. 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 different 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 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.
Examining what Uganda's production sharing agreements 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.

4. High oil prices – Uganda losing out?

Graph 2 also reveals that Uganda's contracts fail to capture increased 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 a 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 risk is held by the Ugandan state rather than Tullow, ie 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 oil revenues, whether the oil price is $100 or $250 – raking in 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) puts it: "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 Norwedian Agency for Development Co-operation (NORAD) in 2008 warned the Ugandan government that its model PSA "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.

“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."[vi]

Significantly, Reuben Kashambuzi, 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."

5. Risks – dumped on Uganda?

Apart from price risk, there is also the risk that something might not go 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 loses 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. (If we only look at income, Tullow takes in the additional $2.1 billion more, as it recovers its costs.)

Although both are carrying some of the risk, the state stand to lose a greater sum of money than the oil company. This despite project risk being 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.

The terms of the PSAs largely protect the companies from price risk & 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.

APPENDIX 1 – PRODUCTION SHARING AGREEMENTS

The PRODUCTION SHARING AGREEMENT (PSA) is a more complex system. 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."

APPENDIX 2 – 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 sies, 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%.

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[i] “Heritage Oil” Credit Suisse April 2009
http://www.scribd.com/doc/15566382/Credit-Suisse-Heritage

[ii] http://www.independent.co.ug/index.php/news/todays-news/90-todays-news/1397-oil-agreements-to-remain-confidential-minister-

[iii] “Worst Kept Secret”, Taimour Lay
http://blog.platformlondon.org/content/worst-kept-secret-tullow-oil%E2%80%99s-contract-uganda

[iv] “Contracts Confidential: Ending Secret Deals in the Extractive Industries”. Revenue Watch International, September 2009
http://www.revenuewatch.org/news/publications/contracts-confidential.php

[v] For a more detailed explanation of Internal Rate of Return and how it is calculated, see PLATFORM’s report “Crude Designs”
http://www.carbonweb.org/documents/crude_designs_small.pdf

[vi] “Mid Term Review of Project 0329 regarding Capacity Building Programme for strengtherning the State Petroleum Administration of the upstream petroleum sector in Uganda”, Norad, August 2008
www.norad.no/en/_binary?download=true&id=49168