

**CRITICAL LEGAL ANALYSIS OF PRODUCTION SHARING AGREEMENTS AND THEIR EFFICACY IN GUARANTEEING A SOUND AND OPTIMAL SAFE GUARD FOR EXPLOITATION OF OIL AND GAS RESOURCES IN UGANDA.**

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**A DISSERTATION**

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**DECEMBER 2021**

## **DECLARATION**

I, Merry Ntungyire hereby declare that this dissertation is my work and it has not been submitted before to any other institution of higher learning for fulfilment of any academic award.

Signed.....

Date.....

## **APPROVAL**

This is to certify that, this dissertation entitled Critical Legal Analysis Of Production Sharing Agreements And Their Efficacy In Guaranteeing A Sound And Optimal Safe Guard For Exploitation Of Oil And Gas Resources In Uganda has been done under my supervision and now it is ready for submission.

Signature.....

DR. ISAAC LUBOGO

Date.....

## **Dedication**

I dedicate this research to Jesus Christ the son of the living God who I dedicated the course to, I also dedicate it to my son Jethro Rutambya who has been the Key that locks our home together, and all my family members that participated in leading to my success.

## **Acknowledgement**

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## CHAPTER ONE:

### GENERAL BACKGROUND

#### Introduction.

This chapter shall cover the background of the promulgation of Production Sharing Agreements (PSAs), what they are and the purpose for which they were introduced. It will unveil the general and specific objectives and research questions of this study; provide the purpose, justification and significance of the study; give a scope of content, time, geography; and provide a synopsis for the entire paper.

#### Definition of a Production Sharing Agreement

A production sharing agreement is a legal contract between one or more investors and any governmental entities to lay out the rights, duties, and obligations of each party for exploration, development, and production of mineral resources in a specific location for a specific time.<sup>1</sup> Of all the legal contracts in the oil and gas industry, a PSA is one of the most significant. It is used as an instrument by all parties to realize a quick return on their investments and increase revenue as much as possible while sharing out the risks.<sup>2</sup>

Typically, the agreement is between the host country, where the minerals are located, and the parties who wish to drill and operate in that country. These parties are usually International Oil Companies (IOCs). The contract regulates the percentage of oil and gas production that each party receives after the recovery of a specific amount of cost and expense by all parties.

The country's government licenses the execution of exploration and production activities to an IOC. The IOC bears the mineral and financial risk of the initiative and explores, develops and ultimately produces the field as required.<sup>3</sup> When successful, the company is permitted to use the money from produced oil to recover capital and operational expenditures, known as "cost oil". The remaining money is known as "profit oil", and is split between the government and the company.

Production sharing agreements can be beneficial to governments of countries that lack the expertise and/or capital to develop their resources and wish to attract foreign companies to do

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<sup>1</sup> CourtHouseDirect.com Team, November 2019, What is a production sharing agreement? [online] available at; <https://info.courthousedirect.com/blog/what-is-a-production-sharing-agreement> (accessed on 25th June, 2021)

<sup>2</sup> Ibid

<sup>3</sup> PSAs grant certain rights, such as exploration and production, from the host government to an international oil company to prospect and develop resources.

so. They can be very profitable agreements for the oil companies involved, but often involve considerable risk.

### The Purpose of Production Sharing Agreements

Also known as PSCs (production sharing contracts), PSAs allow the host country, sometimes called the national oil company or NOC, to maintain a certain amount of control over the development of oil and gas within the country. The agreement also helps NOCs gain the expertise they may lack for exploration and development of hydrocarbons within their borders.<sup>4</sup>

NOCs gain the expertise they need through the international oil companies (IOCs) with whom the agreement is signed. IOCs typically bring the technology and expertise in strategic decision making to the table. In many ways, most of the risks of oil and gas development within these agreements fall on the IOC.<sup>5</sup>

The PSA also outlines how costs and profits are to be shared from a particular oil or gas field from the very start that is to say; Capital expenditures for exploration; Development and operational expenditure for normal operations; and Profits once production begins.

Although the IOC shoulders most of the risks, the more the IOC contributes in the early phases, the higher the share it can expect in return. This is always reflected in what is called cost oil. Therefore, the higher the initial costs of production, the bigger the share of the produce in form of cost oil.

The IOC takes on most or all of the costs and risks of exploration. The NOC begins or increases its contribution after minerals are found, and the site is developed into a production unit with normal operations. The PSA is most beneficial to the NOC because it provides time to generate momentum for project management. Also, the NOC can develop new fields and reservoirs with no risk and little cost to itself.

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<sup>4</sup> Supra note 1

<sup>5</sup> Ibid

### History and Background of Production Sharing Agreements.

Production sharing contracts were first developed in Indonesia in 1966 to give the host government more control over their resources. This type of contract soon became popular with a number of governments when crude oil was in tight supply and the price was rising rapidly.<sup>6</sup>

After independence nationalistic feelings were running high and foreign companies and their concessions became the target of increasing criticism and hostility. In response to this the government refused to grant new concessions. In order to overcome the subsequent stagnation in oil development, which was a disadvantage to both the country and the foreign firms, new petroleum legislation was brought in.<sup>7</sup>

PSAs were regarded as acceptable because the government upholds national ownership of resources. The major oil companies were initially opposed to this new contract form as they were reluctant to invest capital into an enterprise which they were not allowed to own or manage. More importantly, however, the Foreign Oil Companies (FOCs) did not want to establish a precedent which might then affect their concessions elsewhere.<sup>8</sup>

The first PSAs were therefore signed by independent FOCs who showed a greater willingness to compromise and accept terms that had been turned down by the majors. Furthermore, it has been argued that the independents saw this as an opportunity to break the dominance of the big oil companies and gain access to high quality crude oil.<sup>9</sup>

Thus challenged, the major FOCs bit the bullet and entered into PSAs (and found that in reality the foreign firm usually manages and operates the oilfield directly). From Indonesia PSAs spread globally to all oil-producing regions with the exception of western Europe where only Malta offers this type of contract.

PSAs are distinguished from other types of contracts in two ways. First, the FOC carries the entire exploration risk. If no oil is found the company receives no compensation. Second, the government owns both the resource and the installations. In its most basic form, a PSA has four main properties. The foreign partner pays a royalty on gross production to the government.

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<sup>6</sup> Petroskills, April 2021. Introduction to Production Sharing Contracts, [online] available at; [https://www.petroskills.com/blog/entry/00\\_totm/apr21-sub-introduction-to-production-sharing-contracts#.YNW2ZOgzblU](https://www.petroskills.com/blog/entry/00_totm/apr21-sub-introduction-to-production-sharing-contracts#.YNW2ZOgzblU) (accessed on 25<sup>th</sup> June 2021)

<sup>7</sup> Kirsten Bindemann, October 1999. Production-Sharing Agreements: An Economic Analysis, Oxford Institute for Energy Studies, WPM 25

<sup>8</sup> Ibid

<sup>9</sup> Barnes, P. 1995. Indonesia. The Political Economy of Oil. Oxford: Oxford University Press.

After the royalty is deducted, the FOC is entitled to a pre-specified share of production for cost recovery. The remainder of the production, so called profit oil, is then shared between government and FOC at a stipulated share (for example 65 percent for the government and 35 percent for the FOC). The contractor then has to pay income tax on its share of profit oil. Over time PSAs have changed substantially and today they take many different forms.<sup>10</sup>

This paper seeks to analyse the nature of PSAs and criticize the same to establish whether they have served their intent and purpose in Uganda or if there is a lot that still needs to be done in order to guarantee a sound and optimal safeguard for the exploration and production of Oil.

### **Statement of the Problem.**

One highly specific feature of the mineral sector is that exploration and development of mineral resources must take place where the resources are located. Ventures in this sector are of a high-risk nature in the physical, commercial, and political sense as it is difficult to determine in advance the existence, extent and quality of mineral reserves as well as production costs and the future price in the world market. Profitability is not assured, and the fact that the resource is finite requires the continual acquisition of new deposits. Since virtually all mineral ownership regimes are based on state sovereignty companies may have to concern themselves with government policies and regulations in more detail than they would in other sectors.<sup>11</sup>

The government decides whether resources can be privately owned or whether they are state property. If they are state owned the development can be conducted by a state company or it can be contracted to a private firm. Most countries grant development rights to private companies through a process of either negotiation or bidding.<sup>12</sup>

The most common combination of agents in mineral development is a host government which represents a developing country with one or more mineral resources and a multinational company from a developed country. It is not surprising that the objectives of the two frequently clash. The main aim of the multinational firm is profit maximisation whereas the government of the host country is mainly interested in maximising its revenue.

Since the objectives of firm and government do not necessarily coincide and indeed may diverge substantially, it is all the more important that they identify the likely sources of future

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<sup>10</sup> Supra note 7

<sup>11</sup> Ibid

<sup>12</sup> Ibid

conflicts and write a contract that is as comprehensive as possible. This divergence of objectives is frequently manifested in a lack of trust between the contractual partners. The relationship worsens if the government changes existing legislation and applies the new rules to contracts agreed under the old regime. In addition, Mikesell in his study on the copper industry finds that disagreement often arises from the demand for renegotiation which increases with the profitability of a mine.<sup>13</sup> Other potentially contentious issues are the taxation of the (foreign) firm and the split of revenue between firm and government.

PSAs can be complicated. Parties often disagree about various parts of the contract. Because both parties are trying to maximize revenue and minimize risk, it isn't surprising that agreements that seemed pretty clear at signing receive differing interpretations from a party under stress.<sup>14</sup>

Some of the arguments stem from the amount of time the agreements are in place. Personnel and process changes on both sides can change the understanding of the contract language. Changes in fiscal practices or political problems in-country can create other issues. Non-aligned operating or subcontractor agreements and economic cycles cause a few.

Tensions from what may be called "cost oil" develop from the difference in desires of the IOC and NOC. The IOC wants a guarantee that upfront costs are recovered. The NOC doesn't want to allow cost recovery unless it sees these costs as having been "properly incurred." The NOC wants proof of efficiency and due diligence on the part of the OIC before awarding any money.

So-called "profit oil," which is the allocation of production left after "cost oil," is also controlled by the PSA. The NOC wants profit oil right as soon as possible, regardless of what is going on with cost oil. Usually, a tax windfall or oil and gas royalty arrangement has something to do with it. Since tax rates can be 60% to 80%, it isn't surprising the parties would like a hedge against taxes.

For example, IOCs prefer a stabilization agreement to buffer such early profit-taking to make sure taxes and other financial arrangements already in the PSA are not replaced by NOCs trying to puff up government revenues.

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<sup>13</sup> Mikesell, R.F. 1975. *Foreign Investment in Copper Mining*. Baltimore & London: Johns Hopkins University Press.

<sup>14</sup> *Supra* note 1

The expiration of the PSA can cause problems as well. There may be disagreements about everything from the transfer of operations to the accuracy of asset register or termination cost accruals. Most of the problem lands on the IOC in these cases, so the contractor typically works to get the most possible out of a field before the PSA ends.

Production sharing agreements within the United States are also possible, between the lessor (acting in place of a NOC) and the lessee (operating in place of an IOC). However, these agreements don't have the same track record as they do internationally, and they are poorly understood. Typically, a PSA is introduced for an allocation well that royalty owners of tracts crossed by the wells have agreed to share production.

All the above stated are the issues that have ensued with PSAs in the past and therefore this paper will analyse whether similar problems are occurring or are yet to occur in Uganda, concerning oil and gas production.

### **General Objective**

The main objective of this study is to analyse the efficacy of production sharing agreements in guaranteeing a safe, sound and optimal exploration of oil and gas in Uganda.

### **Specific Objectives**

- i. To identify the legal framework that provides for Production Sharing Agreements
- ii. To identify the loopholes and threats presented by the production sharing agreement
- iii. To make recommendations on the findings of the study

### **Research Questions**

- i. What legal framework provides for entering into production sharing agreements?
- ii. What are the loopholes and threats presented by the production sharing agreement to the oil and gas sector?
- iii. What recommendations and conclusions can government act upon going forward?

### **Purpose of the Study**

This study aims to examine the efficacy of the production sharing agreements in the oil exploration, development and production in Uganda. This study also aims to create more literature on the rationale of PSAs and their potential harm if they are not properly negotiated

or bid. Additionally, this research will also examine the reasoning behind the provisions of the PSAs and establish if they benefit the government and the citizens or the IOCs.

In doing the above, this study will identify the loopholes and threats that these agreements pose to the economy of Uganda and suggest ways through which these threats and loopholes can be avoided or minimised if it too late to avoid them.

### **Justification of the study**

Uganda first announced intentions to start oil production and development in 2006. Many years down the road, Uganda has started entering into contracts and agreements with different FOCs for purposes of exploration, development and production of the resource. However, few Ugandans understand or even know the terms agreed upon in those contracts. Partly, this is because the final negotiated contracts are highly confidential and therefore not readily available to read but secondly and most importantly, the model PSA is overly technical for an ordinary citizen of Uganda to comprehend.

It therefore follows that this paper will break down the mysteries of the production sharing agreement and the whole norm of the same in the Ugandan perspective.

### **Significance of the Study**

Uganda recently discovered the presence of oil in the Albertine region and therefore has only entered into a few contracts regarding its exploration, development or production. Therefore, there is little or no knowledge about the operation of these contracts or even experience in as far as Uganda is concerned. Therefore, the study is one of the novel expositions on the nature and content of the PSAs as well as their role or threat in the production of oil in Uganda.

### **Scope of the Study**

#### Content scope

The content of this study will entail an analysis of the Model production sharing agreement of Uganda. It will also cover literature concerning production sharing agreements from all over the world. It will cover the other laws that govern PSAs and an analysis of how other countries have copied with them or why they have ignored them.

### Time scope

This study will cover a period of four months. The literature relied on however will date from the first use of PSAs in 1966 to date for purposes of having a clear picture of the evolution of the same.

### Geographical scope.

This study will majorly be concerned with Uganda. It will only borrow a leaf from other countries that have discovered oil and have harnessed the same for economic development. Uganda is an African country in the eastern region; bordered by Tanzania in the south, Rwanda in the south west, Democratic Republic of Congo in the West, South Sudan in the north and Kenya in the east. The geographical coordinates of Uganda are 1.3733° N, 32.2903° E.

### **Chapter synopsis**

This study shall comprise of five chapters. The first chapter is the proposal, the second chapter is a discussion of the relevant literature. Chapter three will unveil the laws relevant to the PSAs in Uganda and chapter four will identify the loopholes in the PSAs and the challenges that ensue due to the same. Chapter Five will give this study's findings and recommendations.



## CHAPTER TWO: LITERATURE REVIEW

### Introduction

This chapter will provide a review of most of the literature relied upon in this entire study. It will reveal literature concerning the efficacy of PSAs in oil production generally but with special attention to Uganda.

### Literature

- 1. Johnston D, 1994. International Petroleum Fiscal Systems and Production Sharing Contracts, 1<sup>st</sup> edition, PennWell Books, 1421 South Sheridan Road Tulsa, Oklahoma 74112-6600 USA**

The international petroleum industry involves tremendous wealth and power. In many countries' petroleum, whether exported or imported, dominates the economy. Natural resources are the crown jewels. Few industries combine such a dramatic contrast between risk and reward. Countries with petroleum resources carefully guard this wealth. Petroleum taxation is a vital aspect of the industry. Geological, engineering, and financial principles are universal, yet in the realm of taxation, there is added dimension. The subject is so important that understanding at least the basics is mandatory.

One of the absolutely first things a geologist, engineer, landman, lawyer, or economist encounters in the international sector is the diversity of fiscal systems. Countries are unique in the way they structure their taxes, and natural resources get special attention. Governments have no control over the gifts of nature, but they do control taxes.

The focus of the book is on the arithmetic and mechanics of the various kinds of fiscal systems—the factors that drive exploration economics. The emphasis is on practical aspects of petroleum taxation and industry/government relationships. There is also fertile ground in the philosophy of petroleum taxation. It has changed the industry. Legal and operational aspects of contract/fiscal terms are also examined to provide a foundation in the dynamics of international negotiations.

Both industry and government viewpoints are addressed in this book. A complete grasp of the subject requires an understanding of the dilemmas and concerns of both sides. There are few things more discouraging for a national oil company than an unsuccessful licensing round. Yet prolonged, inconclusive negotiations can be equally frustrating for oil companies.

This book covers petroleum taxation and international negotiations. Much of the subject has evolved within just the last 30 years, yet some aspects of taxation are timeless. The terminology has changed over the years and will continue to develop. There is little standardization of terms in the industry, and the abundance of jargon can be rather daunting.

Much of the material provided by the author is inspired by questions most frequently asked on the subject. The best answers are fortified with specific examples and many are used throughout the book. The summaries and analysis of various fiscal terms and conditions are believed to be accurate, and every effort has been made to gather up-to-date information about the current conditions in the countries cited. Examples of fiscal terms used here are drawn from numerous public sources.

The author opines that perhaps more effort could be directed toward the cultural aspect of negotiations and doing business in the international arena.

## **2. Flavio G. I. Inocencio, 2021. Production Sharing Agreements: A Global Legal Handbook, Globe Law and Business Limited**

The Production Sharing Agreement (PSA) is the most widely used host government contract in the oil and gas industry, and is becoming the leading choice for most countries in their relationship with International Oil Companies (IOCs). However, there are many jurisdictional variations, and being aware of and understanding these is crucial for oil and gas practitioners working in this space. This title is the first comparative treatment of this topic and provides a comprehensive, in-depth overview of Production Sharing Agreements in key oil and gas jurisdictions around the world. It offers a rich, critical analysis and evaluation, and features contributions from an international group of leading experts and academics who address the legal, economic and political aspects of PSAs. It also provides guidance on key recent developments by looking at jurisdictions' overall regulatory framework and their relationship with the PSA. This edition covers jurisdictions worldwide, including: -Brazil; -Indonesia; -Kazakhstan; -Nigeria; and -Russia Production Sharing Agreements: A Global Legal Handbook will be of interest to practitioners, academics and anyone who is involved in these contracts. It provides readers with a clear understanding of PSAs in different jurisdictions, and a variety of practical recommendations and takeaways.

**3. Silvana T, 2007. Fiscal Systems for Hydrocarbons: Design Issues, World Bank Working Paper No. 123.**

Although host governments and investors may share one common objective - the desire for projects to generate high levels of revenue - their other goals are not entirely aligned. Host governments aim to maximize rent for their country over time, while achieving other development and socioeconomic objectives. Investors aim to ensure that the return on investment is consistent with the risk associated with the project, and with their corporations' strategic objectives. To reconcile these often-conflicting objectives, more and more countries rely on transparent institutional arrangements and flexible, neutral fiscal regimes. This paper examines the key elements of the legal and fiscal frameworks utilized in the petroleum sector and aims to outline desirable features that should be considered in the design of fiscal policy with the objective of optimizing the host government's benefits, taking into account the effect this would have on the private sector's investment.

The global market for oil and gas exploration has evolved to the point that much of the world's surface open to exploitation has taken on some of the characteristics of a commodity. Governments compete for capital and technology to develop their hydrocarbon sector. In order to devise and apply the appropriate policies, strategies and tactics, each must assess its position in the global marketplace and evaluate its particular situation, boundary conditions, concerns and objectives. Companies look for investment opportunities that suit their corporate strategies and risk-reward profiles. The initial decision to invest and the resulting allocation of revenue and benefits are greatly influenced by the content of existing legal arrangements and fiscal policies.

The fiscal regime can be used to convert a government's policy into economic signals to the market, and influence investment decisions, provided that the framework is clear, is not changed retroactively, and does not discriminate among the actors. Several countries have used favorable taxation of oil and gas to support the development of the sector in addition to relevant sector reforms. The challenge of an efficient fiscal system is to induce maximum effort from the oil companies while ensuring that the host government is adequately compensated.

In designing a fiscal system, a government has to answer the following questions: What is the effect of the fiscal regime on oil/gas output? Does it discourage the development of marginal fields? Does it influence the pace of development? Does it favour early abandonment? Is it

insensitive to oil/gas price and cost variation? In other words, how flexible, neutral and stable is the fiscal regime?

Many fiscal systems around the world make use of sliding scales for the determination of at least one of the following parameters: royalty, bonuses, profit oil/gas split, cost recovery, and taxes. Sliding scales introduce flexibility into the system by allowing it to respond to changes in project variables. Unfortunately, the vast majority of these sliding scales are linked to daily or cumulative production targets. Hence, they are insensitive to changes in economic variables. No wonder that the persistently high level of oil prices in recent years has pushed many host governments to seek improvement in their contractual terms.

High oil prices have also triggered higher demand for services and equipment, which in turn has increased their cost. As many fiscal systems were designed when oil prices were in the US\$15-18 barrel range and finding and development costs were US\$5-9 barrel, these systems no longer efficiently capture the projects' economic rent.

High risks and long project cycles are key elements of the oil and gas industry. As risks can differ substantially by project and over time, an efficient fiscal system needs to be flexible enough to allocate risks equitably, thus minimizing the need for and cost of negotiations or renegotiations. Such a system would be, at least in theory, more stable and better suited to mitigating the investment risk. If correctly designed, the fiscal system has the potential to reduce the procyclicality of investment: a less variable flow of investment is more likely to support the creation of spare capacity, thus reducing price volatility.

In today's competitive market, many diverging interests must be recognized and accommodated to establish an effective and attractive legal and fiscal framework for hydrocarbon exploration and production. No ideal or model regime is available for policy makers to adopt.

Each country's circumstances, needs, and objectives define the key features of an appropriate legal and fiscal framework. This paper provides an overview of the key features of petroleum fiscal systems around the world and attempts to outline desirable features for designing a fiscal regime for the management of a country's petroleum endowment. Its Chapters 2 and 3 provide background material on, respectively, the stages of an oil and gas project and the type of legal arrangements normally used in the petroleum sector. The relative advantages and disadvantages of the tax and non-tax instruments used in petroleum fiscal regimes are discussed

**in Chapter 4. Chapter 5 outlines the features of successful fiscal regimes, while system measures and economic indicators are described in Chapter 6. Finally, in Chapter 7, a sensitivity analysis is used to illustrate some typical fiscal systems' design issues.**

**4. Tengku N.M, 2000. The Indonesian Production Sharing Contract: An Investor's Perspective, Kluwer Law International, The Hague, The Netherlands**

The model contract for oil and gas development known as the Production Sharing Contract (PSC) originated in Indonesia in 1966 and enjoyed over a decade of successful implementation, with minor adjustments, in several oil-producing countries. In more recent years, however, numerous problems have arisen as changes in economic realities have driven the level of private investment down.

This penetrating study, the only one of its kind, uses legal analysis as well as historical data to pinpoint the reasons for the initial success of the PSC and for its subsequent and persistent frustrations for investors. The author first examines the original Indonesian contract, along with the variants adopted in Malaysia and the People's Republic of China, and then proceeds to an in-depth analysis of the main clauses and their amendments and execution in all three countries.

Taking into account various commissioned surveys and emerging policies and strategies espoused by both governments and industry representatives, he concludes with a detailed proposal for an overhauled contract that allows for meaningful adjustments, or even renegotiation, when the balance of interests between parties changes substantially.

Focusing as it does on some central issues in global economic development, The Indonesian Production Sharing Contract will be of great value to lawyers, multinational corporate executives, and policymakers far beyond the Asia-Pacific region.

**5. King & Spalding, 2017. Upstream Government Petroleum Contracts: A Practitioner s Guide to Concessions, Production Sharing Contracts, and Risk Service Agreements, Juris Publishing, Inc.**

The Upstream Government Petroleum Contract in its many forms is the vehicle for some of the most significant outlays of risk capital occurring anywhere in the world at any given time. Yet there are very few comprehensive published sources of information regarding the origins, design, drafting or interpretation of these important contracts. This work, presented by the Global Energy Practice of King & Spalding LLP, is a practical resource for international oil

and gas attorneys, commercial advisors, and other industry professionals who must understand and negotiate these contracts. This book explains the basic forms of the Government Petroleum Contract, the commercial context for those forms, and delivers meaningful analysis of key terms found in those contracts, with the understanding that the market is constantly evolving.

**6. Kirsten B, October 1999. Production-Sharing Agreements: An Economic Analysis, Oxford Institute for Energy Studies, WPM 25**

This study concerns itself with the balance between risks and rewards and the division of benefits among the parties to the contract which have not yet been analysed with the tools of modern industrial economics. The first part identifies the rationale behind PSAs and forms the basis for the following theoretical argument. The author starts with an overview of ownership issues in general and contrast PSAs with other major contract types namely concessions, service agreements and joint ventures (Chapter 2). PSAs are then explained in more detail. Some simulations serve to highlight the sensitivity of the contract parameters to changes in endogenous (e.g. alteration of cost oil) and exogenous (e.g. price change) variables (Chapter 3). This is followed by some theoretical considerations. The framework for the analysis is a principal-agent model incorporating incentive structures and risk and reward-sharing (Chapter 4). In this context, the role of national oil companies is evaluated with regard to both its relationship with the government and its interaction with the foreign contractor.

The empirical part of the study is based on a data set comprising 268 PSAs signed by 74 countries between 1966 and 1998. The various contract variables will be evaluated with regard to global PSA developments over time, regions (South and Central Africa, Eastern Europe, Asia and Australasia, Central America and Caribbean, Middle East, North Africa, and South America), exporting and importing countries as well as OPEC, and onshore and offshore terms and conditions (Chapter 5). This analysis is further disaggregated into selected country studies. Indonesia serves as an example to illustrate how the contracts work in practice as well as how and why they have been altered. In addition the author analyses Angola, Azerbaijan, India, Iran, and Peru (Chapter 6).

While the chapters of this study build up on each other, every attempt has been made for them to be self-contained so that readers can pick and choose the issues that are of special interest to them. The purpose of Chapter 2 is to provide an overall framework of fiscal regimes in the oil industry, and to give a background understanding to readers who are not familiar with the history of oil contracts. Those with a firm understanding of PSAs may want to skip Chapter 3

which explains this particular contract form. If the main interest is in the empirical analysis, it is not strictly necessary to read the theoretical considerations presented in Chapter 4.

In general, the author presents that Production-Sharing Agreements (PSAs) are among the most common types of contractual arrangements for petroleum exploration and development. Under a PSA the state as the owner of mineral resources engages a foreign oil company (FOC) as a contractor to provide technical and financial services for exploration and development operations. The state is traditionally represented by the government or one of its agencies such as the national oil company (NOC). The FOC acquires an entitlement to a stipulated share of the oil produced as a reward for the risk taken and services rendered. The state, however, remains the owner of the petroleum produced subject only to the contractor's entitlement to its share of production. The government or its NOC usually has the option to participate in different aspects of the exploration and development process. In addition, PSAs frequently provide for the establishment of a joint committee where both parties are represented and which monitors the operations.

**7. Nzila M.M,2017. Challenges in Balancing Government and Investor Interests Under a Production Sharing Agreement: Case Study on Tanzania Model PSA 2013, GRIN Publishing**

This paper argues that, although the government is fully confident that there has been enough exploration success to justify higher government take and increase other socio-economic benefits under the new terms, there remain challenges towards encouraging foreign investment in petroleum exploration and development activities in the country. A critical aspect of an oil and gas exploration and production agreement is balancing the interests of the state and investors. The broad objective of any resource rich government is to ensure that it maximizes as much revenues as possible from its natural resource and ensuring that there is always an appropriate level of investment in exploration and development activities in the country. The investors on the other hand are interested to maximize as much profit as possible by minimizing the costs, quick recovery of these costs and working with stable governments. In order to ensure a sustainable development of exploration and development activities in the country these varying state and investor's interest has to be balanced.

**8. Peter D.C and Micheal C.S, 2017. Oil, Gas and Mining: A Sourcebook for Understanding the Extractive Industries, World Bank Group, 1818 H Street NW, Washington, DC 20433, [online] available at;**

<https://documents1.worldbank.org/curated/en/222451496911224999/pdf/115792-PUB-PUBLIC-PUBDATE-6-6-17.pdf> (accessed on 25th June, 2021)

The authors note that all too frequently, development outcomes in the EI sector are less potent and less beneficial than expected. Indeed, the outcomes can become highly damaging to the resource-rich state. Resource-rich developing states typically underperform economically relative to non-resource-rich peers. They score badly against critical human development indicators, experience environmental degradation, and see more than their fair share of social and political instability and violent conflict. Taken together, factors such as these have led some to describe the outcomes as the resource curse or the paradox of plenty

The authors also review some of the dominant thinking about the opportunities and challenges of resource-led development and explain in detail the approach of the book. It charts the emergence of the “development model,” which sees positive outcomes from EI activity if certain conditions are fulfilled. It also provides a summary of the main themes in a very extensive and rich body of literature, in ways that might benefit those unfamiliar with it or who are unable to access much of it.

Current thinking on the interaction between natural resource policy and development policy is still evolving in the light of research and lessons from practice. The end of the long boom from around 2003 to 2012–13 has triggered rethinking and fresh analysis. Further insights and policy recommendations can be expected. Changing perspectives on mining over the past 15 years have significantly shifted the focus from large-scale, capital-intensive mining operations to the mining sector as a whole, including artisanal and small-scale mining, in assessments of sustainable futures. Other examples of changing perspectives include diverse efforts at integration of extractive industry investments into local communities and the regional economy. These efforts include, for example, the design of local benefit policies on procurement and “resources-for-infrastructure” deals championed by investors from various countries, including, notably, China. For the various governmental and nongovernmental bodies now seeking to influence or shape their domestic extractive industries, familiarity with the themes in this body of research can be useful. They inform, sometimes only implicitly; virtually all of the contemporary discussion on policies for resource-led development. In effect, they set the parameters within which the initial strategic decision is made whether or not to engage in development through extraction. They also inform the design and choice of specific operational techniques and instruments, such as decisions on the kind and scope of rights



allocated to investors, the way in which they are awarded, and the appropriate schemes for sharing benefits among public and private parties. Their impact on our understanding of good practice has influenced the approach taken by the authors of the Book.

The authors postulate that investment in the extractive industry (EI) sectors (oil, gas, and mining) presents challenges to policy makers. They arise at the policy design and legal framework stage and are evident in subsequent stages; the management and allocation of revenues and, ultimately, the sustainable development of these resources. Some, perhaps many of these features are common to all three sectors, such as the extraction of resources from under the ground or the seabed, their exhaustibility, or their exposure to a high degree of price volatility. Others are unique to each sector. For example, oil and gas development are alike at the upstream stage (exploration and production), but natural gas takes on distinct characteristics in its transportation and distribution phases.

From a commercial point of view, oil is riskier to find than the mineral deposits typically sought by mining companies, but once oil is found in commercial quantities, the risk is reduced relative to the commercial risk of producing minerals from mining. (Note, however, that this does not apply to environmental risk.) Gas is different again, with its risk profile requiring a complex, expensive infrastructure and a detailed contractual regime to support development. Effective management in the public interest requires recognition of both the common and the unique features of EI in the design of policies and institutions.

The authors examine the fundamental characteristics of EI sector investment, from a perspective that gives priority to public policy making and the design of appropriate institutional arrangements in the public sector. They identify the common features and the key differences among EI sectors and in their investment dynamics. They focus on the relationships that governments have or seek to have with investors in the EI sector rather than on how governments themselves can respond to the challenges and opportunities of natural resource-led development. Some features of the investor-state relationship are relatively constant over time, while others are more dynamic, such as the structure of the industry. It has experienced significant change and become more complex in recent years, due in part to companies from emerging markets making strategic investments aimed at securing future supplies of energy and minerals.

**9. Muhammed A.M, 2010. Petroleum Fiscal Systems and Contracts, Diplomica Verlag.**

This book covers petroleum taxation and international negotiations, and the way to carry out successful exploration and development projects. It examines the petroleum fiscal systems that apply in different countries across the world and how these systems govern the economics of exploration and development for oil and gas. Examples are included to give the reader a wide perspective on the implementation of fiscal systems.

The petroleum fiscal system for a country is a combination of the taxation structure established by legislation, together with the contractual framework under which an international oil company operates with the host government. Fiscal systems vary widely between countries and in some countries, there is more than one system. The taxation structure may, for example, include royalty payments. The contractual framework may be based on concessionary arrangements or on service and production sharing agreements.

The different types of fiscal system are classified and the factors in these systems that govern exploration and development economics are identified. The practical aspects of petroleum taxation and the relationships between oil companies and governments are examined in detail in a chapter that focuses on the resultant contractor and government take under different fiscal regimes. This book also provides descriptions of how exploration development project economics are calculated and how projects are planned and financed. Legal and operational aspects of contractual and fiscal terms are also considered. Topics are addressed from both industry and government viewpoints to give an understanding of the aims and concerns of both sides.

- 10. Tumusiime K, 2021. A Review of The Legal Framework on Production Sharing Agreements in The Oil and Gas Industry: The Ugandan Case Study, [online] available at; [https://www.academia.edu/45499359/A\\_REVIEW\\_OF\\_THE\\_LEGAL\\_FRAMEWORK\\_ON\\_PRODUCTION\\_SHARING\\_AGREEMENTS\\_IN\\_THE\\_OIL\\_AND\\_GAS\\_INDUSTRY\\_THE\\_UGANDAN\\_CASE\\_STUDY](https://www.academia.edu/45499359/A_REVIEW_OF_THE_LEGAL_FRAMEWORK_ON_PRODUCTION_SHARING_AGREEMENTS_IN_THE_OIL_AND_GAS_INDUSTRY_THE_UGANDAN_CASE_STUDY) (accessed on 25th June 2021)**

This research paper analyses the existing laws and regulatory frameworks in the oil and gas sector with a particular focus on Uganda's oil and gas industry. This research analyses the background of the country's oil and gas industry with specific reference to the adaptation of the Production sharing agreement (PSA) model in as far as oil and gas contracts are concerned.

The research commences by undertaking an in-depth analysis of the basic laws, regulatory, policy and institutional frameworks concerning the management and administration of the oil and gas sector. The research then focuses on the legal framework on the PSA model pertaining to the ownership of the resources, the issuing of licenses and concessions, in as well as efforts undertaken to safeguard the effects of signing PSAs on aspects of environmental protection.

This research also critically analyses the weaknesses and strengths of the current legal regime as well as identifies the gaps in laws relating to the applicability of PSAs and measures being taken to tackle such gaps in the regulatory framework of the country and exploring the ways in which aspects of transparency and effective management of the oil and gas industry are concerned.

The research paper also discusses if other factors such as the different stakeholders like media houses, civil societies, non-governmental organisations and International Oil and gas companies have a had a role to play in influencing the PSA model as the most appropriate choice of the Ugandan oil and gas contracts.

Conclusively the research puts forward recommendations regarding how the gaps in the legal framework on the PSA model should integrate or regulate the identifiable influences of other stakeholders in Uganda's oil and gas industry.

## **Conclusion**

The literature concerning production sharing agreements is vast but the one particular to Uganda is minimal. This paper will now add to the little that concerns Uganda for purposes of

enriching knowledge of the contracts entered into by government concerning oil and gas production.

## CHAPTER THREE; RESEARCH METHODOLOGY

### 3.1 Research Design

The study adopted a qualitative method that involves both formal and normative aspects of the existing legal framework on participation of nationals in the oil and gas sector in Uganda.

The qualitative paradigm/approach will be used as means to explore the understanding and meaning which the respondents ascribe to the study problem<sup>15</sup>. This will provide in depth understanding of the respondent's experiences and perspectives as interpreted by the researcher. Therefore, the research will be able to draw statistical inferences and provide in-depth analysis on nationals' participation in access to investment opportunities in the upstream sector of oil and gas in Uganda.

### 3.2 Population Target

The study population comprises of all nationals in the oil and gas sector that have the capacity to conduct employment and decision. For this case the target population is guided by the Ministry of Energy and Mineral Development, 2017.<sup>16</sup> It included 95 responses from the Local Government, District Councils, Project Affected Person, NEMA, PAU, Nationals, Environment Consultants, Cultural Institutions, Health and Security Services, Ministry of Gender, Labour and Social development and National Forest Authority. The reason for the choice of such target population is availability of office bearers, with possibility of verifiable records.

### 3.3 Sample Size

The study was determined by the use of Krejcie & Morgan sample size<sup>17</sup>. This will involve a number of stakeholders currently participating in the upstream sector of oil and gas sector.

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<sup>15</sup>Thanh, N.C., & Thanh, T.T.L. (2015). "The Interconnection Between Interpretivist Paradigm and Qualitative Methods in Education". *American Journal of Educational Science*, 1(2), 24-27.

<sup>16</sup> PAU The National Supplier Database List 28<sup>th</sup> February, 2018 [www.pau.go.ug](http://www.pau.go.ug) (accessed 31 August 2020)

<sup>17</sup> "Krejcie, R. & Morgan, D.W. Determining Sample Size For Research Activity. (1970). " *Educational and Psychological Measurement*, 30(3), 607-610".

Table 1: Showing the distribution of the Sample Size

Category	Population	Sample	Sampling Technique
Local Government	3	2	Radom Sampling
District Councils	2	2	Purposive sampling
Project Affected Person	3	2	Purposive sampling
NEMA	1	1	Purposive sampling
Nationals	70	58	Purposive sampling
Environment Consultants	2	1	Purposive sampling
Cultural Institutions	4	2	Purposive sampling
Health and Security Services	1	1	Purposive sampling
Ministry of Gender	3	2	Random sampling
Labour and Social development	3	2	Random sampling
National Forest Authority	3	1	Purposive sampling
Total	95	74	

Source: Primary Data, 2020

### **3.4 Sampling Techniques**

The study targeted respondents based on random and purposive sampling techniques. Random sampling helped to widen the scope of the participants' selection field. Purposive sampling will be adopted in order to correlate with the regulated nature of the frame wok under review. It helped acquire relevant information on national challenges in the process of making to the active participants. This also helped to interrogate the research questions on access to investment opportunities in the supply chain of the upstream segment of the sector.

### **3.5 Data Collection Instrument**

The study mainly adopted two data collection instrument which included the questionnaire and interview guide.

### 3.5.1 Questionnaire

The questionnaire has the background characteristics of the respondents which will aid relevant information to the study on age, gender, educational level and organizational tenure. It further expresses relevant information to the situation in problem.<sup>18</sup>

### 3.5.2 Interview Guide

The study was based on the general interview guide approach that is an instrument that contains structured question items to collect qualitative data. This interview guide has helped in obtaining detailed information from the respondents however ensuring that the same general areas of information are collected from each interview. This provides more focus and a degree of freedom and adaptability to give room for learning from the respondent's experience. Subject to availability and accessibility, the researcher targets to interview 20 respondents, mainly within the Kampala/Hoima districts.<sup>19</sup> These include key respondents from nationals, PAU, NEMA, Banks and Financial Institutions, Companies resident in the area, Legal Sector, Ministry of Gender, labour and social development, Ministry of Energy and Mineral Development, Cultural Institutions and National Forest Authority.

## **3.6 Data Quality Control**

Validity; the study relied on official and other verifiable data readily available and relevance assessed by the supervisor on the relevance. This manifests wording and clarity of the items in the instrument. In this case the study gathered information from the existing sources and thereafter, it was tested using confirmatory Factor Analysis thus helping in attaining a validity of the study items<sup>20</sup>.

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<sup>18</sup> Appendix A

<sup>19</sup> In view of the Covid-19 challenges –limited access to the border Districts home to the petroleum extraction activities and Cultural Institutions.

<sup>20</sup> Marsh, H.W., Morin, A.J., Parker, P.D., & Kaur, G, Exploratory structural equation modelling: An integration of the best features of exploratory and confirmatory factor analysis. (2014) *Annual Review of Clinical Psychology*, 10, 85-110.

## COMPARATIVE ANALYSIS

Reliability for the qualitative instrument was achieved with the help of consultations with the supervisor, prolonged engagement and audit trails. Data was systematically checked, focus maintained and consistent identification and correction of errors<sup>21</sup>.

### 3.7 Data Analysis

Qualitative analysis was carried out through thematic and discursive methods. By thematic analysis, clusters of text with similar meaning was presented together<sup>22</sup>.

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<sup>21</sup>Morse, J.M., Barrett, M., Mayan, M., Olson, K., & Spiers, J. "Verification strategies for establishing reliability and validity in qualitative research" (2002) *International Journal of Qualitative Methods*, 1(2), 13-22

<sup>22</sup> Madill, A., & Gough, B.. Qualitative research and its place in psychological science. (2008) *Psychological methods*, 13(3), 254. doi: 10.1037/a0013220



## CHAPTER FOUR: THE LEGAL FRAMEWORK GOVERNING PRODUCTION SHARING AGREEMENTS.

### Introduction

This chapter identified and discussed all the relevant laws; domestic and international, that govern the operation of production sharing agreements. These laws include the Constitution, the laws passed by the parliament and international law. It also covered policies set up by government in regards the production sharing agreements.

It is also important to note that Uganda has not for a long time had any streamlined law that manages the Oil and Gas sector. This is because the resource was not of much concern until the early 1980s. Prior to 1980 the colonial government did not believe that oil and gas resources were available in sufficient quantities to justify its exploitation.<sup>23</sup>

The Petroleum (Exploration and Production) Act, No. 20 of 1985 that was repealed by the Petroleum (Exploration, Development and Production) Act 2013 was the only law applicable to the management and regulation of all activities in Uganda's oil and gas sector.<sup>24</sup>

Since discovery of commercial oil and gas deposits, Uganda has through the parliament and the relevant institutions enacted different laws to regulate the oil and gas sector and among these include; the Constitution of the Republic of Uganda 1995<sup>25</sup>, the National Oil and Gas Policy, 2008, the Petroleum (Exploration, Development and Production) Act, 2013<sup>26</sup>; the Oil and Gas Revenue Management Policy, 2012, the Petroleum (Refining, Conversion, Transmission and Midstream Storage) Act, 2013<sup>27</sup>; and the Public Finance Management Act of 2015. A further analysis of the above legal regime shall be discussed below;

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<sup>23</sup> Okuku, J.A. (2015), „Politics, the State and Limits of Oil-led Development in Uganda“. Paper presented at Makerere Institute of Social Research (MISR) Seminar, Kampala p.4; <https://misr.mak.ac.ug/sites/default/files/events/UGANDA%20OIL-LED%20DEVELOPMENT.pdf> (accessed 26th June, 2021)

<sup>24</sup> J. Oloka-Onyango; “Courting the Oil Curse or Playing by the Rules? An Analysis of the Legal and Regulatory Framework Governing Oil in Uganda” <https://www.jstor.org/stable/pdf/j.ctvt9k690.9.pdf?refreqid=excelsior%3Aa7571c7c5f7529c2a0adb8525320fd8d> (Accessed on 26th June, 2021).

<sup>25</sup> This was through the amendment of the Constitution to include the current Article 244

<sup>26</sup> Section 6 (2) (4); the Act was passed to handle upstream oil development

<sup>27</sup> See Section 8 and 9; the Act was passed to handle midstream oil development.

### **The Constitution of the Republic of Uganda, 1995, as amended.**

The 1995 Constitution of Uganda is the primary source of regulation of the Ugandan oil sector. This is because the Constitution is the supreme law of the country and it provides that the Government must ensure that resources are used for the benefit of all Ugandans.<sup>28</sup>

The Constitution under Article 244(2) mandates the Parliament of Uganda to make laws regulating the exploitation, exploration and development of petroleum and mineral resources, and the management of the revenues arising from petroleum exploitation and other related activities.

Article 41(1) of the Constitution of the Republic of Uganda states that every citizen has a right to access information in the possession of the state or any other organ or agency of the state except in cases where the release of such information is likely to prejudice the security, Contract Transparency in Uganda's Petroleum and Mining Sectors Contract Transparency in Uganda's Petroleum and Mining or sovereignty of the state or interfere with the right to privacy of any other person.<sup>29</sup>

### **The Petroleum (Exploration, Development and Production) Act, 2013**

The Act gives life to the National Oil and Gas Policy of Uganda (2008) by putting in place an effective legal framework and institutional structures for ensuring that processes of exploring, developing and producing of petroleum resources in Uganda are carried out in a sustainable manner that guarantees optimum benefits for all Ugandans, both the present and future generations.<sup>30</sup>

The Act also created a conducive environment for the efficient management of petroleum resources of Uganda by providing for institutions to manage the petroleum resources and regulating the petroleum activities which includes licensing, exploration, development, production and cessation of petroleum activities or decommissioning as well as ensuring public safety and protection of public health and the environment in petroleum activities.<sup>31</sup>

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<sup>28</sup>Objective XIII of the National Objectives and Directive Principles of State Policy, and Article 244(1) of the 1995 Constitution of Uganda.

<sup>29</sup> Bagabo, P., Mugenyi, O., Magara, S., and Twebaze, P., Contract Transparency in Uganda's Petroleum and Mining Sectors, Kampala: ACODE Policy Research Paper Series No.94, 2019  
[https://media.africaportal.org/documents/Contract\\_transparency\\_in\\_uganda.pdf](https://media.africaportal.org/documents/Contract_transparency_in_uganda.pdf) (accessed on 26th June, 2021)

<sup>30</sup> Petroleum (Exploration, Development and Production) Act, section 1

<sup>31</sup> Ibid

The Act regulates the licensing and participation of commercial entities in petroleum activities. It expressly states under Section 5 that;

*“Petroleum activities under Ugandan jurisdiction shall not be conducted without an authorisation, license, permit or approval in accordance with this Act.”*

The Act under Section 6 gives power to the Government to enter into agreements relating to petroleum activities consistent with this Act with any person with respect to the granting or renewing a license, the conduct by a person, of petroleum activities on behalf of any person to whom a license is granted.<sup>32</sup>

The Act<sup>33</sup> further states that;

*“The Minister shall develop or cause to be developed a model Production Sharing Agreement or any other model agreement as may be entered into by Government under this section which shall be submitted to Cabinet for approval.”*

Under section 6(3), The Minister shall lay before Parliament the model Production Sharing Agreement or any other model agreement approved by Cabinet under section 6(2) and it shall be this model agreement approved by Cabinet that shall guide negotiations of any future agreements under this section.

The Act<sup>34</sup> also promotes transparency in conducting petroleum activities and to this effect the specific provision in the Act tends to expressly require the Petroleum Authority to

*“ensure transparency in relation to the activities of the petroleum sector and the Authority”*

The NOC in line with above requirement of the law and the principle of Access to information enshrined in the Constitution of the Republic of Uganda<sup>35</sup> makes the model PSAs available to the public through its website.<sup>36</sup>

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<sup>32</sup> Section 6(1), Ibid

<sup>33</sup> Section 6(2), Ibid

<sup>34</sup> Section 11(2d), Ibid

<sup>35</sup> Article 41(1) of the 1995 Constitution.

<sup>36</sup> See <https://www.unoc.co.ug/wp-content/uploads/2018/06/MPSA.pdf> (accessed 26th June, 2021)

**The Petroleum (Refining, Conversion, Transmission and Midstream Storage) Act, 2013.**

This Act was also enacted to give effect to Article 244 of the Constitution. it was promulgated to regulate, manage, coordinate and monitor midstream operations; to enable the construction, placement and ownership of facilities; to provide for third party access to facilities; to regulate tariffs for facilities; to provide for an open, transparent and competitive process for licensing by the minister; to provide for additional and particular health, safety and environment regulations not sufficiently regulated in other laws; and to provide for cessation of midstream operations under the Act and decommissioning of facilities.<sup>37</sup>

The Act covers areas similar to the Petroleum (Exploration, Development and Production) Act that is to say institutional arrangements<sup>38</sup>, licensing<sup>39</sup>, decommissioning<sup>40</sup>, state participation and national content<sup>41</sup>, liability for damage due to pollution<sup>42</sup>, health and safety<sup>43</sup>, and information and documentation<sup>44</sup>.

Section 8 of the Act provides that;

*The Government may enter into an agreement relating to midstream operations consistent with this Act, with any person in respect to the following matters;*

- (a) The grant of a licence;*
- (b) The conditions for granting or renewing a licence;*
- (c) The conduct by a person, of midstream operations on behalf of any person to whom a licence is granted; and*
- (d) Any other matter incidental or connected to the matters in paragraphs (a), (b) and (c).*

The Act therefore makes an effort to allow the government to enter into agreements like the Production Sharing Agreements.

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<sup>37</sup> See the long title of the Petroleum (Refining, Conversion, Transmission And Midstream Storage) Act, 2013

<sup>38</sup> Part II, *ibid*

<sup>39</sup> Part III, *ibid*

<sup>40</sup> Part VI, *ibid*

<sup>41</sup> Part VII, *ibid*

<sup>42</sup> Part IX, *ibid*

<sup>43</sup> Part X, *ibid*

<sup>44</sup> Part XI, *ibid*

Uganda has not ratified any international conventions that would bind it to fulfil other obligations under international law. However, it has signed many contracts for purposes of oil production, with the latest being the East African Crude Oil Pipeline (EACOP).

### **Model Production Sharing Agreement for Petroleum Exploration, Development And Production Or Petroleum Development And Production In The Republic Of Uganda.**

This is a model designed to guide the Ugandan government in entering into oil exploration, development and production contracts. It is comprised of 34 Articles which lay our obligations between the different parties.

The model provides for how participating interests are to be shared between the parties; the responsibilities and grant of rights; the requirement of exploration work programmes; budgeting; the aspect of discovery, development and production; keeping of records, writing reports and keeping data; the aspect of bonuses paid to government; royalties to government; participation of the State in the OGM; recovery of cost; production sharing; the aspect of taxation; valuation and measurement of petroleum; transportation of Oil by pipeline; marketing and lifting; domestic requirements; the aspect of natural gas; training of local expertise, research and employment of locals; title to assets; foreign exchange control; assignment of participating interests; the aspect of prevention of danger to person, property or environment; dispute resolution; force majeure; annual acreage rentals; termination of contracts; accounting and audits; notice; the laws applicable to the contract; the representation of the entire agreement and its amendment; waiver clauses; and the concept of confidentiality.

All these provisions will be tailored to suit each agreement concluded by the government of Uganda with other entities for the exploration, development and production of petroleum.

## **CHAPTER FIVE: CHALLENGES ENCOUNTERED IN USING PRODUCTION SHARING AGREEMENTS.**

### **Introduction**

This chapter highlights the loopholes and threats that come with the use of PSAs. In as much as they are the commonest type of agreement with IOCs, it is also not without significant flaws that could prove fatal.

### **Challenges of Using PSAs for contracts in the Oil and Gas sector.**

Firstly, under a PSA the contractor/IOC finances the largest percentage of the project operations and as a result may concentrate on one field that is lucrative and this may affect the rate at which other exploration areas covered by the contractor and this is risky for the host country.

Secondly, one of the major aims of the IOCs/ contractors is to maximize profits and as a result the contractor can choose to be uneconomical or extravagant in the petroleum operations knowing that such expenses will be fully reimbursed under the cost oil, which would obviously be to the disadvantage of the host country.

The third challenge is in instances when the oil prices shoot up than they were anticipated at the time of contracting. The contractor will earn windfall profits, thereby giving the contractor a greater share of revenue than would ordinarily have been conceded.<sup>45</sup>

The other challenge related to the use of PSAs is the inclusion of stabilization clauses in these contracts. Stabilization clauses like the freezing clauses limit the host countries in making adjustments to the contractual legal regimes even after there's a change in the national law. To many this has been seen as an encroachment on the sovereignty of these host states and it is therefore advisable that host countries should not allow stabilization clauses for along a period of time in order to protect their sovereignty from being interfered with.

The other challenge associated with PSAs is they take away the judicial jurisdiction from the host countries. Commercial disputes that arise out of PSAs are usually referred to international arbitration centres largely because the contractors or IOCs do not trust the technical expertise of the host states' judiciary to handle such disputes arising out of petroleum transactions.

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<sup>45</sup> Omorogbe, Y. (1986) "Contractual Forms in the Oil Industry: The Nigerian Experience with Production Sharing Contracts" 20 J.W.T.L. (1986) p. 342 at 345

Therefore, it is important that countries like Uganda that are engaging in the oil and gas industry for the first time look out for and pay attention to these challenges so that they are adequately provided for in the PSA at the time of contracting.

### **Lacuna in the Law.**

As earlier discussed, the Petroleum (Exploration, Development and Production) Act, 2013 is one of the fundamental laws governing PSAs. However, one of the weaknesses of the Act in line with ensuring transparency, it has no specific provisions relating the penalties or consequences in the event of a failure to disclose the model PSA to the public and Parliament. In this context the consideration of the Parliament remains key given the advisory role it plays in developing and approving of the model PSAs.

Consequently, the Government of Uganda and particularly the ministerial bodies concerned have taken advantage of this lacuna in the law to disregard the role of upholding the availability of these extractives agreements (PSAs) to the public. The constrained availability of PSA to the public impacts the Constitutional right of enhancing the accessibility to information.

Mindful of the above predicament, there is a high likelihood that interested parties might have to seek the indulgence of Courts as exemplified in the case of *Charles Mwanguhya Mpagi and Izama Angelo v. Attorney General*<sup>46</sup> in which two journalists sought to be furnished with copies of PSAs made between the government of Uganda and various oil companies. Those oil companies involved were entrusted with the role of prospecting the exploitation of the oil resources in the country. However, the presiding magistrate declined the applicant's request for disclosure of the PSAs on grounds of the applicants' failure to prove that their disclosure to the public would be used for public benefit only and not harm third party interests. In this regard the reference made to third parties was aimed at protecting of IOCs and Government.

The presiding Court declined making disclosure on grounds of contractual confidentiality clauses. This extrapolates the weakness underlying possible unbalances between notions of contractual confidentiality on one hand and the public right of access to information on the other hand.

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<sup>46</sup> Misc. Cause No.751 of 2009

For PSAs to function in better forms, there is a need to devise measures to minimise the unbalance effects of the above conflict between commercial confidentiality and the citizenry right of access to information.<sup>47</sup>

In accordance with Section 4 of the Upstream Act, which provides for vesting of petroleum rights, the Act restates article 244 of the Constitution of the Republic of Uganda, which vests the entire property in, and the control of, petroleum in its natural condition in, on or under any land or waters in Uganda in the Government on behalf of the Republic of Uganda. The Act<sup>48</sup> further states that

*“for the avoidance of doubt, the Government of Uganda shall hold petroleum rights on behalf of and for the benefit of the people of Uganda.”*

It is therefore clear that these resources do not belong to government which makes public involvement paramount in ensuring that the government is held accountable by the public. Therefore, non-disclosure of these PSAs increases the risks of mismanagement of oil and gas revenues, poor negotiation of PSAs as a result of corruption or incompetence in bargaining terms which may turn out to be inconsistent with the interests of the nation.

### **The theory of Incentives, Risks and Rewards**

Oil exploration and development projects are characterised by large capital investments, long lead times, incomplete information, and in most cases significant differences in the abilities of the parties to bear the risks involved in the venture. Thus, contracts are potentially unstable and one or both signatories may want to renegotiate at some point in time.<sup>49</sup> Furthermore, the inherent instability of contracts may result in some projects not being developed although they are economically attractive in general.

The uncertainties over risk and reward-sharing prevent one or both parties from going ahead with the venture. When a government or its NOC enters into negotiations with a FOC which it expects to provide capital, technology and expertise it wants to ensure that it obtains the best possible deal given the country's specific circumstances. The NOC will take a number of elements into account and evaluate them under different scenarios such as reserve discoveries,

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<sup>47</sup><https://globalfreedomofexpression.columbia.edu/cases/charles-mwanguhya-mpagi-izama-angelo-v-attorney-general-miscellaneous-cause-no-751-200/> (accessed 26th June, 2021)

<sup>48</sup> Section 4(2) PEDP Act 2013

<sup>49</sup> Supra note 7



variations in oil prices, operating costs, and field development. The objective is to maximise revenue under each scenario.<sup>50</sup>

However, given the existence of international competition for risk capital, technology and know-how trade-offs will occur. A further constraint is, of course, the fact that the FOC has the same aim of maximising its revenue. Although countries as well as the two parties to the contract are similar in the goals, they pursue their relative success will be determined by their; bargaining position; negotiation skills; and country-specific circumstances.

The government therefore has to find the optimal, or efficient, contract form for its country. Efficiency can be, and indeed has been, defined in many different ways. Applying the definition of Pareto optimality from welfare economics to contract theory we can say that a contract is efficient when it is impossible to improve one party's terms without making the other party worse off. The efficient contract is then a non-zero sum game. Assume a contract is being renegotiated and is supposed to remain efficient. The renegotiation must either improve the positions of both parties or one partner improves its circumstances without the other one losing anything.

In other words, neither party will be worse off. More specifically, assuming that the government can exploit its bargaining position it will try to offer terms that provide sufficient incentives for a FOC to sign the contract while at the same time ensuring that the foreign partner will not appropriate all incremental benefits. Incentives are therefore one of the main contract features. The second characteristic, which is closely linked to incentives, is the allocation of investment, geological and price risk. Finally, the contracting risk needs to be addressed. By this we mean the possibility, and probability, of non-performance by one or both parties.

#### Risk Allocation and Contract Risk

Investment decisions and strategic planning in general are carried out under uncertainty. The assessment of the risk involved in a project and the appraisal of whether potential rewards justify taking a particular risk are made by finding probability distributions of the measures concerned. Varying degrees of uncertainty that might affect the input variables will be taken into account. The main unknown factors in oil exploration and development are:

- discovery of new resources
- type of resource (oil or gas)

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<sup>50</sup> Ibid

- size of deposit
- economic viability of development
- technological requirements
- future price developments
- general economic and political risks.

The allocation of these risks is a significant factor in the formulation of an efficient contract. Recall that for the contract to be efficient, or Pareto optimal, it has to be considered efficient by both partners. Let us illustrate this. It is conceivable that one party is more exposed to, say, price risk than the other. Hence, the former is at a comparative disadvantage in carrying the price risk. Ideally, the two partners find a risk distribution that takes this into account. This process will inevitably involve a sharing of rewards that is related to the risk allocation. We can develop a similar argument with regard to the cost risk. Total expenditure on, say, an exploration operation depends on a large number of factors such as onshore, offshore or jungle location of the field, the use of two- or three-dimensional seismics, the depth of the deposit and so forth. Several million dollars may be spent on a venture that turns out to be unsuccessful because no commercial quantities of oil have been discovered.

Thus, the successful projects must not only be profitable on their own terms but have to generate enough profit to make up for losses incurred elsewhere. The government will also have views on how the contract should be implemented, that is how the project should be managed. However, they depend on a foreign contractor to provide technology and expertise. Again, there will be a trade-off between the way the government wants the operation to be run and the incentives it has to offer to its counterpart. The government will thus structure the contract so that the FOC finds it in its own interest to manage the project in the way the government itself would have chosen.

Contracting risk, on the other hand, is easier to contain since the non-performance of one party would very likely result in reduced rewards for both partners. If, say, the FOC takes the view that the potential for a future default by the host country exists, it will insist on either incorporating a compensation clause into the contract or on a higher share of the gains from the project (or both).

At the same time the government, too, will be concerned about the FOC breaking its commitment. It will warrant a penalty clause as part of the contract. Furthermore, under a PSA the government owns the resources even once they are produced and can therefore prevent any

export of oil should the FOC default on its obligations. Two crucial points have to be taken into account here. First, compensation and penalty clauses are meaningless unless they are institutionally enforceable. In acknowledgement of this almost all PSAs provide for international arbitration should conflicts arise. Second, both partners have reputations to preserve. One partner's default will become known to the rest of the industry. FOCs would be very hesitant to enter into contracts with a country perceived as an unreliable partner.

Governments, on the other hand would worry about the risk of doing business with a firm that has a history of either not finishing projects or trying to renegotiate its work and other obligations. Additionally, defaulting might make it difficult to obtain investment funds for future ventures.

### Sharecropping

Like financial derivatives oil contracts can be traced back a few centuries to agricultural contracts. There are three main contract forms in agriculture; direct cultivation, fixed rent tenancy, and sharecropping. Their oil equivalents are national oil companies without foreign partners, the US bidding process, and production sharing agreements. Joint ventures and concessions constitute bastard forms with the latter being closer to fixed rent contracts. Sharecropping forms the basis for a tool widely used in industrial economics: the principal-agent model.

While PSAs may only have been introduced to the oil industry in the 1960s, the concept of production sharing has been practised for much longer. It originates in agriculture where the landlord allows the tenant to use his land in exchange for a specified share of production. The terms of the agreement can vary widely. For example, the landlord can regulate in which way and for what purpose the land is used. He may also decide to bear part, or even all, of the costs which in turn will be reflected in the production share he receives. Sharecropping has been criticised as an inefficient arrangement since tenants receive less than their marginal product.

Sharecropping is thus essentially a contract form which combines risk sharing and incentives. This is of particular importance when monitoring effort is costly. Stiglitz<sup>51</sup> and Braverman<sup>52</sup> in their analysis outline two repercussions of this contract form. First, the landlord has an incentive to share the costs of the venture. In the case of agriculture contracts the landlord might for example want to

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<sup>51</sup> Stiglitz, J.E. (1989). Sharecropping. In: Eatwell, J./Milgate, M./Newman, P. (eds). Economic Development. The New Pelgrave. London: Macmillan. pp 308: 15.

<sup>52</sup> Braverman, A./Stiglitz, J.E. (1982). Sharecropping and the Interlinking of Agrarian Markets. American Economic Review. Vol 72. No 4. September. Pp 695:715.

encourage the tenant to use a fertiliser which will improve output. Thus, both parties to the contract can increase their returns.

### Principal-Agent Relationships

As the name suggests, principal-agent theory deals with the actions of a principal (landlord), who owns an asset, and an agent (tenant), who works with that asset and/or makes decisions which will affect the value of the asset. The theory focuses on the optimal design of contracts between the two parties whereby it is possible to have more than one agent. Applied to PSAs this means that the state or the NOC is the principal and the foreign contractor is the agent. If the foreign contractor is a consortium this could be regarded as a principal-agent problem with many agents.

Modern contract theory<sup>53</sup> tells us that contracts are by definition incomplete. If we had only two states of nature, say rain and sunshine, we could foresee that tomorrow we will have either rain or sunshine or a combination of the two. What we do not know is which of the three it will be. A contract based on the possibility of these three events occurring could simply specify that if 'rain' clause x applies, if 'sunshine' clause y applies and so forth. However, in reality there are infinite events that can occur. Some may be more likely than others, and some will be regarded as being more relevant than others. Assume we are an oil company negotiating a contract in a foreign country. Surely, we would be more concerned about say the likelihood of a nationalist terrorist group attacking our oilfield than the likelihood of a plane crashing in the car park. Therefore, the best we can hope for is the formulation of a comprehensive contract. We try to take all possible, relevant future events into consideration and make provisions for those events that we cannot foresee.

The main concern is the relationship between ownership and control when writing a contract within this framework. Recall that the two parties to the contract are a principal and an agent. The principal will want to design a contract such that his interest will be advanced by the agent despite the fact that the interest of the latter may diverge from that of the former. Thus, the principal needs to provide an incentive to the agent that will induce him to act in the principal's interest.

At the same time the principal has to develop a monitoring system that allows him to measure the agent's performance, and that avoids moral hazard. In other words, the principal wants to

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<sup>53</sup> Hart, O. (1995). *Firms, Contracts and Financial Structure*. Oxford: Oxford University Press.

establish a scheme whereby the agent is induced to maximise his efforts in order to get a maximum reward which in turn will also yield maximum profit to the principal. As mentioned before the agent can be a team. This makes the control of moral hazard more difficult as it is harder to detect the source of shirking.

One way to control moral hazard is for the principal to pay the agent a salary and bonus based on the performance of the company. The better the agent performs the higher his income. However, if we have many agents, they may have different utilities of leisure. That is to say somebody may be prepared to accept a lower income if that means he can work less hard and has more leisure. In this case shirking can still persist unless group pressure and/or social cohesion make it unacceptable to each individual agent.

The issue just discussed implies another way to prevent moral hazard. The problem can be avoided if the principal develops a mechanism that enables him to monitor the performance of each individual agent. Also in conjunction with the first scenario is the possibility of incentive contracts which reward agents only on the basis of individual results. One could imagine a scheme whereby the agent has to pay the principal a specified sum in case of underachievement. The most obvious solution to the principal-agent problem is of course for the principal to become his own agent.

### **Conclusion**

It suffices to say that there is a lot to know and understand about PSAs. Uganda and its government must be ready to sail these turbulent waters of the detail of the production sharing agreement.

## CHAPTER SIX: FINDINGS AND RECOMMENDATIONS

### Introduction

This chapter concludes my thesis. It will give an account of the observations made in this study and possible recommendations that can be acted upon to best profit from the use of PSAs.

### Findings of the study.

The presence of PSAs since their inception and adoption by countries like Indonesia which started using PSAs in oil and gas transactions in the early 1960s, PSAs have been one of the most widely adopted and often used as contracting regimes by developing countries in the oil and gas sector.

Developing countries like Uganda commonly lack financial, technical and human resources that are required for undertaking petroleum operations. In order for developing countries to tackle problems of inadequacy associated with exploring, exploiting, producing and developing resources from their oil fields, they contract IOCs.

The economies of less developed countries are dependent on these natural resources and therefore the major objectives of the host state are to maintain and retain ownership and control over these natural resources, generate revenue, promote and enhance economic growth as well as encourage foreign investment.

The extent to which these objectives are achieved is determined by the legal frameworks regulating the PSAs. It is therefore key that the legal frameworks that regulate PSA regimes should be drafted effectively and in line with the host country's goals and objectives of the oil and gas policy and should target the economic rent of an oil and gas project.

It is also important that the legal frameworks meet the required international standards not only in protecting the sovereignty of the host state but also in encouraging the success of foreign investment in the sector.

Given the politicised nature of the oil resource, some of information is inaccessible due to the absence of transparency especially in relation to certain PSAs documents detailing the records, participants and background of negotiations on oil and gas exploration and production. Most of the PSAs have a confidentiality clause which bars any of the parties to the contract from issuing or allowing access to information on PSAs to non-parties. This limited the researcher since current PSAs would not be accessed in public domain.

When designing a fiscal system, a government aims to maximise revenue from its natural resources while at the same time providing sufficient incentives to foreign investors. The oil industry relies on many different contract forms. One of the most widespread types is the production-sharing agreement.

Under a PSA the FOC receives a share of production as a reward for its investment and operating costs and the work performed. It usually bears the entire exploration cost risk and shares the revenue risk with the host country. The contract is signed before exploration begins and the foreign partner will therefore expect significant rewards later on in the life of the contract.

The FOC's revenue is made up of cost oil and profit oil, while the direct sources of revenue for the government can comprise royalties, profit oil, bonuses, taxes, customs duties, and indirect benefits that arise from price caps. PSAs do not divide profits out of market proceeds but instead divide the physical production after allowing a portion of output to be retained by the FOC for the recovery of pre-production and production costs. This means that costs can only be recovered once oil is produced.

A source of disagreement at this point can be the definition of costs. This is the basis for the determination of the profit-oil volume that is the part of production remaining after costs in the form of oil have been deducted. The sharing of production follows a pre-agreed split between the FOC and the state or its NOC. In theory the state controls the operation but de facto the risk-taking private partner manages the project unless the NOC takes up its option to participate in the venture, which has become more common over time.

PSAs address the important issue of ownership of oil reserves which has made this contract form politically acceptable in most developing countries. Before the introduction of PSAs, the concession agreement vested, for all intents and purposes, the ownership with the foreign company at the wellhead. Under PSAs reserves and all installations and plants built by the FOC are government property. The PSA is attractive to foreign firms because they can book the reserves in their balance sheets notwithstanding the fact that they do not own them. It seems that the rationale is that the company is entitled to produce for a long period of time, in many cases for as long as the field is alive. During this time, it can book the reserves because of access rather than legal title.

A PSA does not allow for up- or downgrading of the contract terms once the exploration period comes to an end and information about the exact size and characteristics of the deposit is available. The same problem arises at the start of exploration because the work obligation during this phase is finalised before work begins. It would appear that it is in the FOC's interest to have a short initial exploration period and then negotiate the work programme for subsequent phases if these are needed.

Once development commences cost oil enables the FOC to recover its costs even if the project is not profitable. Under different contract forms costs are often deductible from taxable income which in the case of PSAs is the FOC's profit oil. If the project does not realise any profit, then there might not be a taxable income against which to deduct costs. With cost oil, however, at least part of the expenditure can be recovered provided there is some cash flow. Not surprisingly, FOCs are therefore keen on high-cost recovery limits and some PSAs indeed set the maximum cost oil at 100 percent. The problem for the government is that the higher the cost recovery the lower the nominal profit oil to be shared between the parties. One way around this dilemma is to impose royalties thereby generating a guaranteed minimum revenue stream.

Depending on the discount rate marginal projects might not be profitable if the fiscal system is not sufficiently geared towards economic rents. Governments have recognised that this kind of rigidity can work detrimentally to their goal of maximising revenue. Thus, most PSAs now offer sliding scales for the calculation of profit oil.



## **Recommendations**

The Petroleum (Exploration, Development and Production) Act, 2013 is almost the only Act which is entrusted with regulating petroleum activities in Uganda. It also provides for the establishment of institutional and regulatory structures such as PAU and NOC<sup>54</sup> that are largely responsible for licencing of commercial entities in the oil and gas sector.

Under the Petroleum (Exploration, Development and Production) Act, 2013 the roles of the Minister tend to often interfere with those of established institutions. For example, under section 6 of the Act, the minister is required to draft a model PSA that is subjected to approval as set out in the Act.

The Energy Minister in Uganda is a public servant who can be transferred from one ministry to another at any time since the ministerial position is a political appointment. In most cases the Minister and the deployed members in the office are lacking the required expertise in drafting a competitive PSA in the oil and gas sector. In my view this function ought to have been placed under institutions such as the PAU or the NOC that have specialised experts capable of handling and dealing with petroleum activities.

It is therefore recommended that these roles and functions could be harmonised to realise the rationale for which institutional structures like the PAU and NOC that were established under the Petroleum (Exploration, Development and Production) Act, 2013. The research justifies that the Minister's roles ought to be mainly limited to supervisory duties rather than participation and regulation that remains within the scope of the PAU and NOC.

According to the Petroleum (Exploration, development and Production) Act, 2013, the purpose of the Act is operationalising the National Oil and Gas Policy of Uganda by establishing an effective legal framework and supporting institutional structures to ensure that the exploration, development and production of petroleum resources of Uganda is carried out in a sustainable manner that guarantees optimum benefits for all Ugandans, both the present and future generations.

This is key because this Act is remains one of the guiding laws in oil and gas operations of Uganda. However, neither does the Act nor the PSA model define the term "Dispute" in as far as petroleum activities are concerned. The purpose of parties participating in the oil and gas operations entering into a PSA is to clearly state their obligations so that both of the parties can

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<sup>54</sup> Section 9 and 42, Petroleum (Exploration, Development and Production) Act, 2013

protect interests from being affected in case of a default or a dispute arising out of the contractual relationship. The researcher finds it commendable that the term dispute should be defined to avoid misinterpretation legally.

This research therefore recommends that both the PSAs and the Acts should define the term “Dispute” and also shed some light on some of the lawfully permissible mechanisms of dispute settlement in the oil and gas operations.

IOCs being the major funders and highest risk bearers in oil and gas operations, they tend to have a comparably higher bargaining power compared to the host states. It is therefore recommendable following from such a possibility that countries like Uganda, countries which are investing or exploiting petroleum resources for the first time should prioritise in the training of experts in not only the drafting of international contracts but also the negotiating of such contracts. The government should also embark on giving the technical staff in the oil and gas sector hands-on training. An arrangement that might be achievable through making collaborative partnerships with popular IOCs like TOTAL, TULLOW, and CNOOC among others that are currently engaged in the exploration and development of Uganda’s petroleum resources.

And in the case of Uganda this will promote the local content policy and uphold the national local content bill. Local content in the oil and gas sector focuses on citizen participation in the oil and gas activities and this can be done through citizenry empowerment through training, capacity building, technology transfer, employment and service provision. In countries like Uganda where the industry is still growing as earlier noted it is prudent for governments to embark on giving the technical staff in the oil and gas sector hands-on training and exert more efforts to ensure that citizens competitively take part in the oil and gas sector.

## **Conclusion**

The sector of oil and gas in Uganda is still growing. For this reason, numerous decisions have to be made regarding its exploration, development and production. Production Sharing agreements provide a great opportunity for Uganda to acquire the expertise required to extract the oil and still have ample profit oil after removal of the cost.

The government should strive to give PSAs more relevance in the laws of Uganda so that it is readily known and acceptable to all the parties affected by the terms concluded in the contract.

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