THE REPUBLIC OF UGANDA

OIL AND GAS
REVENUE MANAGEMENT POLICY

February 2012

MINISTRY OF FINANCE, PLANNING AND ECONOMIC DEVELOPMENT
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Foreword

The discovery of oil and gas provides the country with an opportunity to fast-track the economic and social transformation process. However, oil and gas resources are finite and the associated revenues can be immense. If not well managed, these revenues have the potential to undermine the macroeconomic, budgetary and governance structures that have been built over the last two decades leading to waste. In order to sustain the economic and social transformation process beyond the oil and gas era, we will have to manage the oil and gas revenues in manner that will encourage other sources of wealth creation.

The 2008 National Oil and Gas Policy required that an appropriate framework be put in place to aid the sustainable management of oil and gas revenues. This policy provides details on how the anticipated revenues shall be managed and integrated into the existing Government systems with a view of mitigating the overall impact of these revenues on the economy. The policy requires the highest standards of transparency and accountability in the management of oil and gas revenues and gives the institutional and governance structures to be used to achieve this. Lastly, to promote harmony and social cohesion, the policy provides for a mechanism for the sharing of royalty revenues with the local governments within the oil producing region.

I would like to acknowledge the Government of the Kingdom of Norway for the technical and logistical support to the Government of Uganda towards the formulation of this policy. We are grateful to all the other development partners, institutions and individuals for their ideas and contributions during the consultation process which culminated into formulating the policy. Special thanks to all the Government officials and institutions that worked tirelessly in the preparation of this policy.

Maria Kiwanuka
MINISTER OF FINANCE, PLANNING AND ECONOMIC DEVELOPMENT
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<th>Full Form</th>
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<tr>
<td>BoU</td>
<td>Bank of Uganda</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>EITI</td>
<td>Extractive Industries Transparency Initiative</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>ITA</td>
<td>Income Tax Act</td>
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<td>MDA</td>
<td>Ministries, Departments and Agencies</td>
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<td>MFPED</td>
<td>Ministry of Finance, Planning and Economic Development</td>
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<td>MTBF</td>
<td>Medium Term Budget Framework</td>
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<td>Medium Term Expenditure Framework</td>
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<td>Medium Term Fiscal Framework</td>
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<td>NATOIL</td>
<td>National Oil Company</td>
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<td>OAG</td>
<td>Office of the Auditor General</td>
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<td>PAYE</td>
<td>Pay As You Earn</td>
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<td>PFAA</td>
<td>Public Finance and Accountability Act</td>
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<td>PSA</td>
<td>Production Sharing Agreement</td>
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<td>URA</td>
<td>Uganda Revenue Authority</td>
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<td>VAT</td>
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Executive Summary

The discovery of oil in commercial quantities in Uganda in 2006 has raised the prospect of oil production in the near to medium term. The completion of field appraisals and development of necessary infrastructure will determine the exact volume, costs and timing of production. Available information based on appraisals thus far indicates that oil production in Uganda will generate significant revenues to the Government. The prudent management of these oil resources will help the Government to meet its long-term development objectives.

The Government acknowledges that there are significant challenges associated with the management of substantial resource revenues. These challenges are mainly of a macroeconomic, budgetary and governance nature. World-over, countries that have successfully used natural resource revenues to transform their societies have adhered to best-practices in natural resource revenue management. For Uganda, the manner in which these challenges are dealt with will determine the long term competitiveness of the economy, in particular the non-oil sectors and the extent to which these resources will transform society.

In January 2008, the National Oil and Gas Policy was approved, which articulates the policy and operational framework for prudent management of oil and gas resources. Specifically, this policy provides for the establishment of a legal and institutional framework which will govern the assessment, collection, use and accountability of oil and gas revenues. In this regard, the Oil and Gas Revenue Management Policy details the framework under which the anticipated oil and gas revenues will be managed.

Key Policy Highlights:

The following are the key policies to guide the management of oil and gas revenues to achieve sustainable economic and social transformation for the country.
Assessment and Collection of Government Oil and Gas Revenues

The current fiscal regime guiding the operation of the oil and gas sector is derived from the Petroleum and Exploration and Production Act (PEPA) Cap 150, Production Sharing Agreements (PSA), the tax legislation, and other relevant laws. Expected revenues include but not limited to; signature bonus, royalties, profit oil, income tax, dividends, premiums, in-kind-revenues, excise duty, and VAT.

The collection and administration of Government revenues from oil and gas activities will be the responsibility of URA, in collaboration with other relevant technical departments under the Ministry responsible for Energy. These institutions will work together in the day-to-day monitoring of production activities to ensure proper measurement, assessment and collection of the Government revenues. Additionally, any revenues to be derived from disposition of the in-kind oil by the relevant Government agency will be deposited on the petroleum fund in Bank of Uganda.

Oil Revenue and Inter Governmental Fiscal Transfers

The Constitution vests with Government the responsibility of managing any natural resources on behalf of the people and to ensure its equitable distribution. In order to promote social cohesion and stable investment and production environment, 7% of all royalty revenues shall be set aside for sharing between local governments located in the oil and gas producing areas. The mechanism of sharing these revenues amongst the local governments will take into account intra-regional fairness, level of production and sustainability principles.

Macroeconomic Policy Management

The Government will continue to pursue prudent macroeconomic management policies, irrespective of the oil revenues. These policies will emphasize a sustainable path for the non-oil budget deficit, aimed at minimizing the Dutch disease effects, boom and bust cycles and excessive borrowing. A special Fund is to be set up in the Bank of Uganda, with a twin objective of financing the budget and saving for future generations.
Non-oil Tax Revenues

The oil and gas sector has the potential to undermine the Government objective of enhancing non-oil domestic revenue efforts. For this reason, Government will continue to focus on improving the non-oil tax revenue efforts given that oil is a finite resource and the revenues volatile.

Oil and External Financing

The Government will continue to focus on infrastructure investments such as transport, energy, ICT, etc, as the key growth drivers. These priority infrastructure investments will require substantial resources for which oil and gas revenues will contribute to their financing. However, these resources will not fully finance these investments and therefore Government will continue to solicit for grants and to borrow in accordance with National Debt Strategy. No debt will be securitized on the basis of future oil and gas revenues.

Fiscal Rule for Managing Oil and Gas Revenues

Oil and gas revenues are subject to volatility in volume and prices. Therefore, a fiscal anchor to manage volatility in oil and gas revenues will be used to mitigate the risks to the economy from natural resource wealth. This fiscal anchor will be the non-oil non-grant budget deficit, consistent with the broader macroeconomic management objectives. The anchor sets out the level of oil and gas revenues to be integrated on annual basis within the overall fiscal framework in a manner that limits the impact on other sectors of the economy.

Oversight and Controls

To ensure transparency of oil and gas revenues, the collection, management, and use of all oil revenues shall be subject to detailed oversight as provided for under the Constitution, National Audit Act and the other relevant public finance management laws.
Chapter One

Introduction

1. Background

Exploration work undertaken in the Albertine Graben confirmed the existence of reserves of oil in commercial quantities in Uganda during 2006. Estimates show that oil production could be sustained at around 150,000 barrels per day for 20-25 years based on the estimated reserves of 2.5 billion barrels. Production at these levels for 20 years would equate to total production of 1,095 million barrels. Following this discovery, the country has since embarked on the next phase which involves appraisal, development and production.

The emergence of the oil and gas resources presents opportunities as well as challenges. The key advantage is that oil and gas revenues are generated by the discovery of a sub-soil asset - “a gift from nature”. The discovery of oil and gas resources is expected to translate into an improvement in the Government’s wealth and hence the expansion of the country’s economic growth and development.

However, experience shows that with oil revenues, there can be challenges, especially if these revenues are not well managed. The key question is how to avoid falling into the ‘resource curse’ trap, a complex phenomenon in which, through several economic, institutional and political economy transmission mechanisms, oil and gas revenues could translate into economic stagnation and waste.

One of the transmission mechanisms is through the “Dutch Disease” phenomenon, which is a reference to a set of negative macroeconomic effects caused by a large increase in resource-funded spending. Large increases in spending, if mainly allocated to domestically produced goods, can push up domestic prices, and eventually appreciate the nominal and real exchange rate. This often results in a shift of capital and labor into the production of non-traded goods and an erosion of the competitiveness of the non-resource economy.
A second transmission mechanism of the resource curse takes place through the extreme volatility of oil and gas revenues, which can lead to wastage, boom and bust cycles, and excessive borrowing. Wastage arises out of the pressure to expand expenditure beyond the execution capacity of the economy and ensuing poor quality programs. Further, it could also arise from frequent upward and downward adjustments of expenditure (in line with unpredictable revenue inflows as a result of volatile price movements) and in the process impacting on Government spending programs. Excessive borrowing arises from the notion of anticipating future oil booms, which is used as a basis to guarantee borrowing.

A third transmission mechanism arises from the fact that resources are generated by depleting a non-renewable non-financial asset, which means that oil and gas revenues are temporary and exhaustible. The non-renewable nature of these revenues implies that independently of their modality, resource revenues could be considered as derived from consumption or sale of an existing asset rather than additional income. This means that such revenues cannot be sustained.

This therefore calls for the establishment of a robust fiscal framework to cover all aspects of collections, utilization, savings and investment of oil and gas revenues in a manner that will ensure that the gains made over the last 20 years in the areas of economic and fiscal management are not reversed.

The objective of this paper therefore is to provide details of a policy framework on the planning and budgeting practices to cope with the oil and gas revenues which are volatile and exhaustible. The Government will establish a framework for assessing sustainable long-term projections of oil revenues; outline the long term strategy for the allocation of resources among alternative uses and designing and implementing medium term fiscal plans conducive to achieving the country’s long-term development strategy. The assessment shall take into account the size of the resource proven reserves, costs of production, realistic projections for world prices, the extraction and depletion rates and the fiscal regime with all the uncertainties attached to these aspects.
The paper is organized in seven parts. Chapter two addresses issues of fiscal regime, collection and administration of oil and gas revenues. This is followed by a discussion in chapter three of the macroeconomic management framework, including inter-temporal issues relating to savings of oil revenues. Chapter four discusses the oil and gas revenue sharing arrangement between the Center and local governments in the oil producing region. In chapter five, the banking, accounting and audit arrangements are discussed. This chapter also talks about the establishment of a Petroleum Fund. Governance issues and the general aspects of petroleum fund management are presented in chapter six, which is followed by concluding remarks in chapter seven.
Chapter Two

Fiscal Regime, Collection and Administration of Oil & Gas Revenues

2.1 Fiscal Regime
The current fiscal regime\(^1\) for the petroleum sector is based on a production sharing contract or agreement (PSA). Under this arrangement, the oil companies are contracted by Government and are rewarded an agreed share in the production. In its simplest form, the fiscal provisions of a production sharing agreement constitute four main components; royalties, cost recovery oil, profit oil, and income tax.

*Royalties*
Royalties are payments in lieu of resource extraction and are based on volume or value of the resource extracted. These are made either in cash or in kind. Royalties are paid on commencement of production.

*Cost Recovery Oil*
Cost oil is a reference to the portion of oil produced/extracted and retained by the contractor in order to reimburse the costs associated with exploration, development and production. In the PSA, there is a limit to the amount of oil that can be retained as cost recovery oil in a given period. Under this arrangement, the contractor is allowed to carry forward any costs that are not recovered, for recovery in subsequent years. However, not all costs incurred by the contractor are recoverable. Any cost eligible for recovery must be approved by Government.

*Profit Oil*
This refers to the share of production remaining after the contractor has retained the share attributed to cost recovery. This is then split between the contractor and Government.

\(^{1}\) Other regimes include; concessions and other forms of service contracts. The Government might choose a different regime for future licenses. The same principles for managing these revenues will apply.
according to an agreed formula. The share due to Government is either paid in cash or is taken in kind.

*Income Tax*

After deducting royalties, cost recovery oil and profit oil share, the contractor’s profit oil share is subjected to income tax in accordance with the income tax laws. Figure 1 shows the mechanism of the production sharing agreements.

*Figure 1: Mechanism of production sharing agreements*
State Participation

The Government might choose to exercise its right to participate in the production of oil and gas with oil companies². In this case, the contractor’s share of profit oil net of income tax will be shared between the Government or her nominee (NOC) and the contractor accordingly. Government may decide to allow her nominee (NOC) retain her share of state participation or transfer it to Government after marketing. Depending on the mode, the value of share of Government participating interest may be obtained by the Government directly or indirectly in terms of dividends. The value obtained by the Government from state participation is part and parcel of the overall Government take.

2.2 Legal Framework

The legal framework shall include a broad definition and coverage of resource revenues including; royalties, taxes, bonus payments, dividends, premiums, and in-kind revenues. In addition, the legal framework will mandate that all revenues be reported in the official fiscal documents on gross basis and including all adjustments.

2.3 Collection and Administration of Revenues

The oil and gas sector will generate a significant amount of different cash streams that will in turn generate revenues for Government (see box 1). Streamlining the collection of these revenues is essential to ensure transparency and accountability. In this regard, all revenues shall be collected and deposited in a special petroleum fund to be established in Bank of Uganda. This will include the proceeds from the sale of Government’s share of oil extracted that will be received in kind.

²The current PSAs, allow state participation of between 15 to 20 percent.
In some instances, the Government shall elect to receive its share of production of oil in kind. At this stage, the NATOIL\(^3\) will take charge of marketing the oil. However, once disposed of, the revenues received will be deposited directly into the special petroleum fund account in Bank of Uganda within a time period to be stipulated in the public finance law. The operational costs of NATOIL will be financed through the Government budget and the mode through which the company (NATOIL) will access funding for its activities will be stipulated in the law that will establish it.

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\(^3\) In line with the 2008 National Oil and Gas Policy, a National Oil Company (NATOIL) will be established whose main role, amongst others will be to take charge of marketing the oil received in kind.
Oil and Gas Valuation

The value of oil and gas produced is a function of a price and the quantities. The quantities to be produced within a given period will be agreed between the Ministry responsible for Energy and the oil companies, in line with their development plans. For purposes of determining the price, a multi-institutional committee will be established. The committee will include officials from the Ministry of Finance, Planning and Economic Development, Ministry of Energy, Uganda Revenue Authority, and any other specialized agencies to be determined by the Minister. The Committee will also set the price at which profit oil received in kind by NATOIL will be disposed of.
Chapter Three

Macroeconomic Management Framework

3.1 Issues
Uganda’s macroeconomic framework has proved relatively successful over the last two decades. It has delivered consistently robust real GDP growth, moderate inflation rates and, in most years, balance of payments surpluses. However, the Ugandan economy is evolving and generating new challenges for macroeconomic management as it becomes larger, more urbanised and more developed. The production of oil on a commercial scale in Uganda will have a profound impact on the economy and therefore require a more robust macroeconomic framework.

The discovery of oil and gas presents a unique opportunity for Uganda’s to accelerate its development process, given that the sector is expected to generate significant additional revenues for investment. However, utilization of these resources will take into regard the economy’s absorptive capacity in order to sustain the gains made in the last two decades in the areas of macroeconomic stability, economic diversification, structural transformation and governance.

To avoid the mis-use of natural resource revenues, which would lead to what is commonly referred to as the “resource curse”, an appropriate framework will be put in place to address challenges that arise with the integration of oil and gas revenues into the overall macro economy and the fiscal framework. International experience suggests that many countries rich in natural resources have been unable to address these challenges end up being poorer and less stable than countries that are less endowed.
3.2 Challenges of Managing Natural Resource Revenues

The unique characteristics associated with natural resources separates them from other sectors of the economy and as such, the ensuing revenues pose considerable challenges for macroeconomic policy management. These challenges include; managing expectations, exchange rate appreciation pressures and its implications on the tradable good sector, diversification of the economy, inflation control, consolidation of revenue collections from non oil sources, managing the Government budget in the face of volatility in oil prices, the risk of channeling oil resources to non-productive projects, and the need for equitable inter-generational distribution of oil resources. These challenges are discussed in detail in the sections below;

a. Natural resource revenues are finite in nature. They tend to show a bell-shaped pattern and this poses challenges for; (a) transforming a windfall to a permanent income (b) avoiding overheating the economy and instead sustain higher growth and (c) avoiding “Dutch Disease”. In many natural resource rich countries, earnings from these resources constitute the bulk of government revenues. Where the authorities have failed to strike the right balance between resource and non resource revenue generation, the result has been an over reliance on the former as the main source of budget financing. The non resource revenue sector is often neglected which poses the risk of government over relying on one commodity for its fiscal revenues.

b. Experience also shows that with a new found resource, a major temptation in a number of new natural resource countries has been to use oil wealth to, among other things finance reductions in taxes in the non-resource economy. While in principle this could boost economic growth, by reducing taxes that distort the behavior of households and firms, empirical evidence has shown that this is not always the case. Allowing non-resource sector revenue collections to fall would have the disadvantage of leaving little fiscal space for increasing public spending or investment. Natural resource wealth immensely benefits the country where the budget is re-oriented towards export sector diversification and import-substitution production activities.
c. Given the volatility and finite nature of oil revenues, Government will remain committed to enhancing the non-oil related revenues. Our revenue effort has stagnated at about 12-13% of GDP over the last decade and there’s scope for further improvement. The policy for improving the tax revenue effort by half a percent of GDP per annum will be maintained. More support will be made towards improving tax and revenue administration.

d. **Volatility of oil revenues.** Due to the volatility of oil prices, oil revenues can vary enormously from year to year. Past experiences of oil price developments confirm that prices tend to follow volatile patterns and have been known to change by as much as 50 percent or more from one year to the next. Short term prices shocks can result in even sharper movements in revenue flows. Given the volatility associated with oil revenues, this will present a persistent governance challenge with regard to fiscal policy and investment. Protection of the budget from potentially large fluctuations in oil revenue is a big challenge and must be managed in order to maintain macroeconomic stability. The challenge is further aggravated where oil revenues are allowed to constitute a significant proportion of the country’s GDP, and especially overall fiscal revenues. Therefore, the oil revenue volatilities will not be allowed to spill into the fiscal operations, to avoid the adverse effect on economic management, as well as undermine the medium term fiscal framework, and in the process constrain investment planning.

3.3 Impact of “Dutch Disease”

a. Among the other economic challenges, resource booms normally cause the currency to appreciate as demand increases. The rise in demand for these resources, coupled with high prices leads to a ‘crowding-out’ effect of the non-resource sectors, as the value of the domestic currency appreciates or as factors of production shift to the resource sector due to the relatively higher returns. This makes the non resource sectors less competitive. Such a phenomenon normally referred to as a ‘Dutch Disease’, which results from a mis-match between demand and supply.
b. Given the expected appreciation of the currency that would come with sustained large foreign inflows and the effect of such appreciation on export sector competitiveness. Therefore, Government will focus on other factors that determine export competitiveness. The country’s land-linked situation, high transport costs, high fuel costs, and inadequate energy supply, remain important considerations in this respect. Oil and gas revenue should optimally be applied to generate growth, productivity gains and also address the geographical disadvantage by linking the country to the rest of the world.

3.4 Benchmark for Oil Prices
The estimate of the average level of oil and gas revenue which can be sustained over the long term would be based on realistic and relatively conservative projections of future oil prices, so that Government does not incur expenditure commitments which will subsequently prove unaffordable because of oil revenues falling short of the forecast levels. A mechanism will be put in place to determine a benchmark petroleum price, for purposes of determining the amount of revenues from petroleum activities to flow into the budget.

3.5 Fiscal Policy Management.
The Government shall formulate a long-term development/fiscal strategy. The strategy shall assess; (i) how much of the petroleum revenue should be spent and how much should be saved for future use, (ii) what to spend on, (iii) how to address vertical and horizontal imbalances, and (iv) the accountability and public support for those fiscal policy decisions. The strategy and policy tools by which Government shall establish and implement fiscal policy decisions depends on a number of factors; the size of petroleum revenues compared to the rest of the country’s economy, the expenditure path, institutional capacity, and the structure of the economy.

Controlling the rate of growth of expenditure in the wake of wind-fall revenues is needed to avoid “stop-go” public spending, unsustainable “boom-based” foreign borrowing, exchange rate appreciation, Dutch disease effects, consumptive rather than productive sector investment, rent seeking, and a dis-incentive to private sector investment. The “savings”
question is about saving for short and medium term revenue financing of the budget and long term saving for inter-generational equity.

The ultimate key fiscal policy objective is to ensure the long term fiscal sustainability of public expenditure and macroeconomic stability. Policy tools and instruments will be designed to address many of these challenges and to ensure sound macroeconomic management. As part of the framework, a Petroleum Fund will be established whose proceeds will be invested for the benefit of current and future generations. The Fund will be separate from the Bank of Uganda’s own foreign exchange reserves. A Petroleum Fund is no substitute for sound fiscal management but a well designed and managed Fund shall help fiscal policy and support a policy of wise-long term management of petroleum wealth. Therefore, the full integration of the Fund with the overall fiscal framework will be critical to maintaining macroeconomic stability.

The pressures to increase public spending on infrastructure, education and health services, and raise public services must be properly guided. This is crucial as Government will be hard pressed to show rapid dividends from the country’s oil wealth. This notwithstanding, the fiscal prudence established for over the past two decades, will have to be preserved to help ensure that oil and gas revenues are used productively to address the infrastructure and social needs of a fast growing population.

3.6  Fiscal Rule for Managing Petroleum Revenues

Natural resource rich countries adopt fiscal rules in order to prevent an unsustainable use of the resource revenues. There are various options for fiscal rules, which are linked to either future revenue streams, resource prices or a budget balance that excludes natural resource revenues (see box 2 for fiscal rule options). In choosing an appropriate fiscal rule, a number of considerations must be made; it must be simple, minimize volatility in revenues to the budget, must be counter-cyclical, ensures a sustainable debt path, and must be consistent with medium term expenditure objectives.
In the short to medium term, the non oil and non grant budget deficit will be used as the fiscal anchor, which will be complemented by a limit in the growth in Government expenditures. This rule links overall expenditures to the non oil related revenues rather than to total revenues. The rule will provide the flexibility desired to control overall Government spending to a level that is consistent with the economy's needs and absorptive capacity in the short to medium term. However, in the long-term, adjustments will be made to ensure that overall Government spending is restored to a level that is equivalent to the return on the Petroleum Fund's assets. Therefore, there will be a deliberate effort, to ensure that savings of oil and gas revenues are made for future generations.
3.7 Oil Revenues and Budget Execution
In theory, oil revenues should be handled in the budget execution process as the rest of Government revenues. However, oil revenues can create great pressure to either increase spending above the budget appropriations or divert the use of oil revenues to non-priority spending.

The Government shall enhance expenditure controls to prevent budget overruns. The main challenge is how to combat pressures to increase the annual withdrawals from the Fund above the level budgeted. The Medium Term Budget Framework shall clearly establish the annual withdrawals from the Fund by; (i) ensuring political commitment to the approved budget (ii) avoid surprises, and last minute requests, by formulating (and regularly updating) prudent and sound commitment plans (iii) enhance accounting, reporting and internal control systems. The Government shall establish a well designed mechanism for orderly amendment of the budget.

The Government will conduct a mid-year review of budget execution. In case of an important shortfall in financing resources or an increase in expenditures beyond the Government’s control; the Government shall; (i) seek additional financing, without undermining the sustainability of the Government’s net financial position, (ii) reduce, reallocate some budget allocations or increase non-oil related revenues, (iii) request Parliament for authorization for a higher than budgeted withdrawal from the Fund. Finally, Government will strengthen budget formulation, accounting classification and reporting systems.

3.8 Oil and External Financing
The current external financial support is in form of direct support through the budget (loan and grants) and off budget - through bilateral and multilateral arrangements, and through NGOs. This support has been targeted towards both infrastructure and social development programmes. However, given the resources available, the focus of Government shall be
directed towards asset formation, through mainly infrastructure investment. On the basis of the estimated production profile thus far, production is projected to start at a modest daily output of about 20,000 bpd, which will gradually rise to 60,000 bpd, and further to 160,000 bpd by the end of the 15th year, and in line with demand projections. From these projections, it’s clear that Uganda’s oil output will not be sufficient to meet all the financing needs nor replace the external support in the near term. Therefore, Government will continue to engage development partners and solicit for external assistance which is consistent with our growth and development objectives. New borrowings will be done in line with the National Debt Strategy and the Partnership Policy.

3.9 Public Investment Planning
Global experience shows that resource rich countries have often fallen into a resource trap in which gross domestic income rises fast, while non resource related domestic output stagnates. Oil resources are a depletable resource, and consequently it is important for sustainable development that the rents from resource extraction lead to income from other activities as a means to overcome the resource trap. Therefore, the manner in which rents from oil are spent is critically important. However, the policy in general and spending on public investment programs in particular should aim for the continued building of capacity in the non oil related sectors for sustainability, given that oil the revenue may not be sufficiently abundant to provide a permanent income stream.

Government will continue to work towards strengthening the public investment management system in MDA’s in project selection, management cycle planning, budgeting, execution, reporting and assurance. This is our most binding constraint. Given the need for urgent investment in infrastructure, Government needs to prioritize and phase projects as we improve our absorptive capacity. And given the capacity constraints, we cannot fix or build every road, railway, water system and human development simultaneously.

3.10 Local Content
Country experiences from all over the world have shown that local enterprises are the drivers of economic activity and development. The natural resource industry in general
and the oil and gas sector in particular can however be elusive to local enterprises in the absence of well thought out policy measures to ensure their integration in the industry. In general, the promotion of local content in the oil and gas sector entails the development of local skills, technology transfer, and use of local manpower and local manufacturing. More specifically, it involves building a workforce with the required skills mix demanded by the sector and building a competitive local supplier base.

In addition to the obligations to the oil companies provided for in the PSAs, there will be a deliberate effort to address vocational skills development in the sector in the short term. Guidelines will also be developed to be used by sectors to assist them in aligning skills development with the needs of the oil sector. And over the medium term, Government will focus on expanding and strengthening the delivery of oil and gas sector related education and training through local institutions, and supporting capacity development of local private sector players in the provision of ground handling and logistical services.
Chapter Four

Oil and Gas Revenue Sharing

4.1 Oil Revenues and Inter Governmental Fiscal Transfers

The Constitution\(^4\) vests with Government, on behalf of all people, the responsibility over any natural resources in, on, or under any land or waters in Uganda. The Constitution also provides for the sharing of royalties between central Government and areas where the natural resources are discovered. In order to promote transparency and accountability, royalty revenues will be shared with recognized local authority structures (currently local governments) within the oil producing region.

Oil and gas related revenue shared with local governments, if not well managed, can be a source of destabilization to local government financing, budgets and investments. In order to avoid the potential to undermine local government operations, oil revenues to be shared with the local governments ought to be pre-specified. In this regard, a maximum of 7 percent of royalty revenues arising from gross oil and gas production will be shared with local governments and communities, which will be directly affected by oil production. The remaining 93% is to be retained by the centre for the benefit of the entire country. To ensure equitable distribution of the royalty revenues amongst eligible local governments, a mechanism will be set, which shall take into consideration the following principles in allocating the royalty to local governments:

i) *Intra-regional fairness*: Local governments within the oil resource rich region\(^5\) will be affected by oil and gas activities undertaken in this area. As a result, this area is bound to incur, particularly social costs related to these activities. The mechanism will ensure that each local government within the region is compensated for these costs, irrespective of the stage of oil activities undertaken in the locality.

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\(^4\) In Article 244

\(^5\) To be determined in consultation with the Ministry responsible for Energy and Minerals Development
ii) *Level of production:* The royalty allocated to an eligible local government will take into account the level of production derived from within its boundaries. However, local Governments without production activities will only benefit on the basis of the intra-regional fairness principle.

iii) *Sustainability of local revenue:* As oil is a finite resource whose revenues are volatile and uncertain, there is need to protect and encourage non-royalty revenue collection effort in the oil resource regions. The mechanism for royalty revenue sharing will take into account the need to smoothen releases to local governments, even after oil production ceases.

Taking into account the above principles, the proposed formula derives the royalty share as a function of the sum of the weighted population share and the weighted production share as represented below:

\[
LGRS_i = \frac{R}{2} \times (\text{Weighted LG population share}_i + \text{Weighted LG Production Share}_i)
\]

*Where;* 
\[LGRS_i - \text{Individual local government royalty revenue share,}
\]
\[LG = \text{Local government}
\]
\[R = \text{Total local government royalty share}
\]

R/2 seeks to split the royalty into two halves, with one half to be shared on the basis of population distribution and the other half on the basis of the level of oil and gas produced within the local government boundaries.

The *weighted LG population share* represents the proportion of the population of a particular local government area to the total population summed up over all the local governments located in the oil rich region. It recognizes that the entire population within the oil and gas region will be affected by the industry activity regardless of whether their specific localities are in production and therefore must receive some form of compensation.
The weighted LG population share ensures that all eligible local governments within the oil and gas resource region get a share of the royalties irrespective of the stage of activity undertaken. The *weighted LG production share* represents the share of output from a particular district in the overall level of production. It seeks to compensate local governments on the basis of level of oil and gas produced within their boundaries.

Once determined, the revenues shall be transferred to the local governments in the form of block grants through the budget. Local governments will then be required to spend the grant on key areas, including education, health, water, roads and bridges, and production (market infrastructure, pests and disease control). Within this framework of revenue sharing, the responsibility for stabilization of royalty revenues shall be managed by the Central Government, as local Governments' capacity to manage such mechanisms is limited and could cause tension between the Central and Local Governments budgets if not stabilized.

*Sustainability of non-oil Revenues*

To take into account the principle of sustainability and to protect the non-oil revenue efforts, the royalty shares transferred to each of the local governments in any given year shall not exceed 100% of their non-royalty related revenues. If the royalty share derived from the formula above is in excess of 100% of a local government’s non-oil revenues, the balance shall be held in trust by the Minister responsible for Finance and used to stabilize their future budgets.

*Allocations to Sub counties and Cultural Institutions*

Each local government may in consultation with the Ministry responsible for culture and the other local governments, agree and allocate a share of their royalty grant to cultural institutions recognized by the Constitution in their localities.

The sub-counties within each of the eligible local government shall be entitled to share in the royalties received. However, the royalty shared with sub-counties shall be net of subventions to cultural institutions and will be on the basis of weighted population.
Chapter Five

Banking, Accounting and Auditing of Oil and Gas Revenues

5.1 Establishment of the Petroleum Fund

Ordinarily, the oil and gas revenues should, like all other Government revenues, be deposited in the revenue account of the Consolidated Fund, and allocated in accordance with normal budgetary process. However, (i) to help crystallize public support in building a resource buffer for the future; (ii) given the complexity of accountability for multiple petroleum revenue streams (iii) and to provide an easy and transparent way to present and manage the stocks and flows of oil revenues and the anticipated challenges that management of these revenues pose, the resources must be managed under a transparent and segregated arrangement distinct from the Consolidated Fund, into which all revenues directly attributed to petroleum activities are deposited. The activities and revenues as defined in the PSAs shall be incorporated in the relevant laws.

A Petroleum Fund is to be established in Bank of Uganda, which will be under the control of the Ministry of Finance Planning and Economic Development on behalf of Government. The Fund will be a “financing fund” with the following objectives:

a) Budget Financing

b) Provide for Savings for future Generations

The Fund shall be in Bank of Uganda and will be denominated in foreign currency. The inflows and outflows of oil and gas revenues shall be coherently integrated into the budget process.

5.2 Legal Framework for the Petroleum Fund

A legal framework is to be put in place to provide for the management of all public finances, including oil revenues. The new public finance law will inter-alia define the
nature/types of revenues and how the different accounts will be managed. The law will also prescribe the rules on depositing and withdrawing from the Fund, how the principal and interest earnings may be employed by Government and what procedures are to be followed to limit pro-cyclical influences on fiscal policy.

5.3  **Deposits and Withdrawals from the Fund**
The Petroleum Fund will receive all revenues from oil taxes, non-tax related revenues and any revenues realized from the disposal of the Government’s share of profit oil received in kind (see figure 2). To enhance transparency, payments shall be made by electronic transfer directly to the Petroleum Fund by the entity bearing the payment obligation.

Withdrawals from the Fund will be determined in the annual budget and aimed at financing the non-resource budget deficit. Drawing from the Fund shall be regulated in accordance with established rules. Most importantly, the withdrawal shall be only for purposes of; (i) financing the non-resource budget deficit and (ii) savings for future generations. The amount of withdrawal each year, as determined through the budget process, will be transferred from the Petroleum Fund to the Consolidated Fund. Any authorization of larger than budgeted withdrawals from the Fund will be subject to transparent and stringent conditions to ensure accountability and minimize misuse.

In order to avoid parallel budgets, the Petroleum Fund proceeds will not be used to finance any projects directly outside of the Government budgeting system. Any domestic spending of petroleum resources will have to be incorporated in the MTFF/MTEF and subjected to appropriation by Parliament.
5.4 Asset Management Practices

After deducting the amount required for the financing of the budget, the balance of the revenues in the petroleum revenue holding account will be transferred to a petroleum revenue investment reserve of the Petroleum Fund. The investment reserves will be invested in accordance with an established investment strategy. The responsibility of designing the investment strategy of the Petroleum Fund shall lie with the Ministry of Finance, Planning and Economic Development. Within the Ministry, the department responsible for Government assets shall work closely with the governance structures of the Petroleum Fund to be established. However, the department shall not have direct investment responsibilities, which would remain with the Central Bank.

The management of the balance of the Fund shall be integrated into the Government assets and liabilities framework. The balance sheet of the Fund shall be consolidated with other Government financial operations into a statement of assets and liabilities that is audited and presented within a prescribed period to Parliament. The statement shall include information on public debt and asset liability position.
5.5  **Accounting and Auditing of Oil and Gas Revenues**

In order to align the activities in the oil and gas sector with existing financial management requirements, a new chart of accounts will be introduced and will be used by all companies engaged in the petroleum sector. This will be the basis for determining contractual expenses used in apportioning cost oil. In addition, this will define the cost recognition and accumulation policies to be used for determining cost/profit oil and the allowable expenditures.

The Auditor General will audit the Petroleum Fund twice in a given financial year and submit reports to Parliament. The audits shall include audited and reconciled data on oil revenues, production, sales and prices.

5.6  **Accountability and Transparency of Government Operations**

All transactions involving oil and gas revenues to the Government, including by the NATOIL shall be made transparent by expanding the content of the budget documents to include, annual budget estimates, the long term oil revenues projections, the MTFF/MTEF, a detailed explanation of the long term fiscal strategy and its assessment, an estimation of the Government’s non oil sources of financing, and the share of the budget appropriations allocated to priority spending.
Chapter Six

Governance Issues

6.1 Governance of the Petroleum Fund

Good governance, professional management and oversight are key principles for the success in the management of natural resource funds. These will be the attributes that will be emphasized to avoid the ‘resource curse’.

In terms of governance structure, the overall ownership and control of the Petroleum Fund will be vested in the Ministry of Finance, Planning and Economic Development (MFPED). The Fund will be managed by the Central Bank on behalf of Government. Oversight function will be provided by Parliament and the Auditor General.

6.1.1 Responsibilities of the Minister of Finance

The roles of the MFPED will be:

1. Establish an Investment Advisory Committee.
2. Exercise ownership and control over the Petroleum Fund through the Investment Advisory Committee.
3. Issue strategic investment guidelines/benchmarks to the Central Bank.
4. Draw up the management contract for the Fund.
5. Monitor the overall performance of the Fund.

Within the Ministry of Finance, a Department for Asset Management will be established whose main responsibility will be to coordinate the activities of the Petroleum Fund.
6.1.2 Responsibilities of the Investment Advisory Committee

The key responsibility will be to oversee the operations of the Petroleum Investment Fund. This will involve;

1. Establishing the broad investment policy.
2. Setting reporting requirements of the fund manager.
3. Reporting periodically to the Minister responsible for Finance and the public, on the governance of the fund, subject to independent audits.
4. Setting ethical codes and standards for the fund management.
6.1.3 Responsibilities of the Central Bank

In line with the Oil and Gas Policy, Bank of Uganda will be the Fund manager and will be mandated with the operational management of the Petroleum Fund on behalf of MFPED. The key responsibilities will be;

1. Implementing an agreed Investment Strategy;
2. Establishing appropriate structures to manage the Petroleum Fund.
3. Actively manage the Fund to achieve a reasonable return;
4. Risk control and reporting;
5. Provide professional advice on investment strategy;
6. Report to the Investment Advisory Committee on the performance of the Fund on a quarterly basis;

6.2 Investment of the Petroleum Fund Proceeds

Investment of the Petroleum Fund shall be made in low risk and well diversified investment portfolios abroad. This will ensure that the risk to these resources is minimized while at the same time guarantee availability, in the event they’re needed to deal with domestic emergencies. In addition, investing a significant portion of the petroleum revenues abroad minimizes the risk to the economy arising out of domestic spending from large foreign exchange inflows. However, in order to ensure sound management, all investments of the Petroleum Fund shall be made in accordance with the investment policy approved by the Petroleum Fund Investment Advisory Committee.

6.3 Oversight and Controls

To ensure transparency of oil and gas revenues, the collection, management, and use of all oil revenues shall be subject to detailed oversight as provided for under the Constitution, National Audit Act and the other relevant public finance management laws.

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6 The circumstances will have to be prescribed in the public finance law and shall require Parliamentary approval.
6.3.1 *Petroleum Fund Investment Advisory Committee*

There will be a Petroleum Fund Investment Advisory Committee which will provide technical advice to the management of the Petroleum Fund Investments. The Committee will constitute 5 persons, including the Secretary to Treasury, and 4 other persons to be appointed by the Minister responsible for Finance. These persons must have a distinguished service career, be of unquestionable integrity and demonstrated competence in fields relevant to fund management and investment.

6.3.2 *Petroleum Fund Audit*

The Auditor General will audit the Petroleum Fund twice in a given financial year and submit reports to Parliament. The results of these audits will be made available to the public within a stipulated timeframe following the conclusion of the audit exercise.

6.4 *Financial Reporting and Accountability*

Reporting on activities of the oil and gas sector shall include information on the resource reserves, costs of production, realistic projections for world prices, the extraction and depletion rates and the fiscal regime, contribution to the Government’s wealth. Accounting of oil reserves and their depletion is essential to establish whether oil production is being depleted in a sustainable way. The accounting of oil reserves helps to put in perspective the volume of the country’s resource wealth and deter over-expansive budgetary and borrowing policies.

Quarterly reports on the operations of the Petroleum Fund shall be prepared by the Investment Advisory Committee in a manner prescribed by the legal framework and submitted to Auditor General. The reports will in turn be submitted to Parliament and also made public in a stipulated time frame.
6.5 **Transparency**

The policy provides that all parties involved in the management of oil and gas revenues shall observe the highest standards of transparency. Only in cases where it is demonstrated that certain information should be treated as confidential, the relevant laws will ensure that transparency mechanisms are put in place and there is free access to public information.

In addition to strengthening the institutional, legal and regulatory frameworks, this policy will require reporting standards to adhere to internationally accepted best practices. The revisions to the relevant laws, once complete, will facilitate Uganda’s joining of global transparency forums, such as the EITI.

6.6 **Encumbrances**

The assets of the Petroleum Fund are the property of the people of Uganda and held on their behalf by the Government. These assets shall not be encumbered in any way, whether by way of guarantee, security, mortgage or any other form of encumbrance. This requirement will be clearly stipulated in the public finance law.
Chapter Seven

Conclusion

Unlike other revenues, petroleum revenues and their management present opportunities as well as unique policy challenges. On the one hand, the emergence of the oil and gas resources will translate into an improvement in the Government’s net-worth. On the other hand, these revenues can present significant challenges, especially if mismanaged. The key policy challenge will be to avoid the so called resource curse, a phenomenon through which several economic, institutional and political economy transmission mechanisms, oil and gas revenues translate into economic stagnation and waste.

This policy provides details on how the anticipated oil revenues shall be integrated and managed within the existing public finance laws with a view of mitigating the overall impact of oil revenues on the economy. There shall be a framework to formulate and assess long-term projections and impact of oil revenues. This will include a strategy for the allocation of resources amongst alternative uses, and designing and implementing medium term fiscal plans conducive to achieving the country’s long-term development strategy. The assessment shall take into account the size of the resource proven reserves, costs of production, realistic projections for world prices, the extraction and depletion rates and the fiscal regime with all the uncertainties attached to these aspects.

The paper concludes with a key recommendation that the expenditure path is what will be used as the appropriate rule to anchor fiscal policy in the management of oil and gas revenues. However, more detailed work will be undertaken on the mechanisms of integrating oil and gas revenues within the existing fiscal and monetary frameworks. In addition, a public debt sensitivity analysis shall be undertaken on an annual basis in order to ascertain our sustainability levels given the anticipated high oil revenues flows.
Appendix

Appendix 1: Revenue Management Policy Issues Summary

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<th>Issues for Uganda &amp; International experience</th>
<th>Policy Principles &amp; Proposals</th>
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</thead>
<tbody>
<tr>
<td>A. Tax &amp; Revenues</td>
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<tr>
<td>Taxation &amp; Revenue flows</td>
<td>PSAs and ITAs set out terms of payment by oil companies and rates. Government profit oil is tax in economic substance.</td>
<td>Signature bonuses, surface rental, royalties, taxes and receipts from sale of Government share of profit oil will accrue. Oil revenues should be handled like any tax or other receipt and as such, the collection and assessment is provided for in the Income Tax Act, in line with provisions in the PSA.</td>
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<tr>
<td>Revenue collection</td>
<td>Experience from collection of non tax revenues through several MDAs suggest that transparency, accountability and efficiency of collection will be improved if all revenue are streamlined through one collection agency.</td>
<td>URA will take on this responsibility and oil flows shall be payable to a special account in Bank of Uganda in line with the relevant laws.</td>
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<tr>
<td>Payment into account</td>
<td>A Special Account – Petroleum Fund in Bank of Uganda, into which petroleum revenues will be credited; Payments shall be made by electronic transfer directly into the oil account by the entity bearing the payment obligation.</td>
<td></td>
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<tr>
<td>Currency units</td>
<td>Collection of oil flows and taxation will be in US$.</td>
<td></td>
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<tr>
<td>B. Expenditure</td>
<td>Options include (a) Use overall budget deficit (b) primary non-oil deficit as % GDP. Option (a) has more uncertainty and makes planning difficult, while (b) is more certain but not clear what desirable level of deficit should be.</td>
<td>The Fund shall be coherently integrated into the budget process as it is to operate as a Government account rather than a separate institution. The Fund will be managed by MFPED; Non oil budget deficit will be used as an anchor for Government spending. This will take into consideration the economy's</td>
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<tr>
<td>Integration with fiscal policy</td>
<td>Due to higher uncertainty surrounding tax and non-tax revenue at this time, fiscal policy needs an ‘anchor’ i.e. fiscal control, public spending efficiency, standards of approval and execution and maintain stability objective.</td>
<td>Oil revenue management will be integrated with the Medium Term Fiscal Framework and Medium Term Budget Framework. The non oil budget deficit is to be used as the anchor for fiscal policy.</td>
</tr>
<tr>
<td>Spending limits</td>
<td>What should the cap be and how ‘hard’? Norway has no cap, which is flexible but might be open to uncertainty or political influence; Sao Tome &amp; Principe has hard cap, Timor-Leste has cap based on measures of ‘sustainable income’</td>
<td>In the short to medium term, spending of oil and gas revenues from the petroleum fund will be limited to funding the non oil budget deficit agreed as part of the budget process. In the long term, the principle should be to have the expenditures aligned to the permanent income from the petroleum fund.</td>
</tr>
<tr>
<td>Sharing of revenues</td>
<td>RM law could specify spending only on priority sectors, or regional or local allocations (e.g. Sao Tome &amp; Principe).</td>
<td>For equitable distribution, oil and gas revenues to be spent within the domestic economy will be channeled through the normal budgetary process.</td>
</tr>
<tr>
<td>Sharing of royalties</td>
<td></td>
<td>Royalties will be shared between the Center and the directly affected local governments in the ratio of 93% and 7%, respectively. The sharing of royalties amongst the affected local governments will take into consideration the population and production levels in these local governments.</td>
</tr>
<tr>
<td>C. Establishing Fund</td>
<td></td>
<td>Petroleum Fund should be a financing fund, reflecting government savings from petroleum wealth.</td>
</tr>
<tr>
<td>Type of account</td>
<td>The fund should be treated as the savings to government from fiscal surpluses that arise from petroleum revenues, over &amp; above those that can be used in MTFFs and MTBFs. Could be trust fund, special account, sub account of reserves or segregated account held by Treasury. Offshore depository or domestic account?</td>
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<tr>
<td>Fund Purpose (savings, stabilization etc)</td>
<td>Should the fund be for monitoring oil flows, stabilization against price fluctuations, savings etc? What is desired size of permanent fund? Experience shows that price fluctuations can lead to expenditure fluctuations.</td>
<td>The oil revenue fund should be used to meet the needs of both current and future generations. Given the unpredictability associated with oil prices, conservative price estimates should be used to derive projected resources.</td>
</tr>
<tr>
<td>D. Management &amp; Investment of Fund Reserves</td>
<td></td>
<td></td>
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<tr>
<td>Deposits &amp; withdrawals</td>
<td>Best practice requires clear rules and principles for proper management with regards to depositing and withdrawing funds.</td>
<td>For purposes of transparency, payments by the tax entity will be made directly into the special collection account by electronic transfer. For withdrawals, a specified number of signatories will be required in line with public finance laws and the Memorandum between MOF and BOU. Unless otherwise, transfer of funds out of the Fund shall be limited to only two purposes: budget financing and savings for future generations.</td>
</tr>
<tr>
<td>Investment policy</td>
<td>There's need to have clear mandates in the law over degree of discretion allowed to investment committee e.g. Sao Tome &amp; Principe has little discretion with committee submitting plan to National Assembly for approval</td>
<td>MFPED will be in-charge of the Fund but will delegate Fund management to Bank of Uganda. There will be an Investment Advisory Committee comprising competent persons to be appointed by the Minister who will have overall responsibility over investment policy for Petroleum Funds.</td>
</tr>
<tr>
<td>Investment managers</td>
<td>Selection and oversight of portfolio managers needs to be determined as well as their mandate and discretionary powers.</td>
<td>The PFM law and the Memorandum with the Central Bank is to be amended to provide a clear governance structure covering the main Petroleum Fund asset management functions; The portfolio should be managed by experts appointed through an investment committee.</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>Kuwait has Future Generations Fund subject to executive branch policy making and management by Kuwait</td>
<td>There will be a limit to risky investments, no domestic investment from the Fund. Principle will be to limit investments to</td>
</tr>
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<tr>
<td>Borrowing</td>
<td>Some advantages can be seen in borrow against oil revenues for human or capital investment, but the general experience is negative. As such, any such borrowing has been explicitly prohibited in law in the U.S (Alaska), Norway and ST &amp; P.</td>
<td>Borrowing against oil resources or assets held in the fund to be explicitly prohibited; Revenue management law should prohibit the pledge or other such use of oil resources or Petroleum Fund assets as security for loans.</td>
</tr>
<tr>
<td>E. Governance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parliamentary &amp; government oversight</td>
<td>There's need to have regularity in process of revenue management and spending and to reduce the temptation to meet short term budgetary needs through oil revenues.</td>
<td>Domestic spending will be through the normal budgetary process which is subject to appropriation by Parliament. Review existing laws to ensure sufficient provision for oversight of collection, management and use of all oil-derived revenues.</td>
</tr>
<tr>
<td>Oversight board</td>
<td>Given the significance of revenues and limitations on existing institutions, countries have set up additional oversight institutions to provide specific oversight functions and complement existing institutions.</td>
<td>Oversight functions will be provided by the mandated institutions according to the relevant laws.</td>
</tr>
<tr>
<td>Audits &amp; reporting</td>
<td>International initiatives include “Publish What you Pay” and “Extractive Industries Transparency Initiative” &amp; IMF Guide on Resource Revenue Transparency 2005.</td>
<td>The Chart of Accounts is to be reviewed to align oil and gas transactions with the existing financial management requirements. Investment committee will report its activities periodically to Government and the public and its activities should also be subject to periodic audits;</td>
</tr>
<tr>
<td>Transparency</td>
<td>In some countries, this is</td>
<td>The scope of public information to be availed</td>
</tr>
<tr>
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<tr>
<td>Public procurement</td>
<td>achieved through creation of supervisory bodies involving civil society; Requirements providing for creation of a public information office to enable public access to payment data and contracts.</td>
<td>should be agreed and mechanisms put in place on how to access the information. In addition, Government will make the necessary arrangements to facilitate the joining of EITI.</td>
</tr>
<tr>
<td></td>
<td>International experience suggests this is most prone to corruption (favoritism).</td>
<td>Revenue Management law should stipulate that all significant contracts and agreements relating to oil revenues or to oil resources must be subject to open competitive tenders.</td>
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