

THE REPUBLIC OF SOMALILAND
MINISTRY OF ENERGY AND MINERALS

Upstream Petroleum Policy

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1. Introduction

The Minister of Energy and Minerals ("the Minister") notes that petroleum activities are currently ongoing without legislation to regulate the sector in place. Although no commercial discoveries have been made so far, the Minister considers it important to establish a proper legal framework for the petroleum activities as soon as possible. The Minister therefore submits a Bill for discussion by government with the aim of agreeing on how to regulate the upstream petroleum sector based on resource management principles.

If discoveries are made, it is the aim of this Minister to avoid the so-called 'resource curse'. The main tool in this regard is recognising that revenue from the petroleum sector will normally be temporary and be subject to volatile fluctuations of the petroleum prices. The Minister therefore proposes to prepare for the establishment of a petroleum fund to offset the likely negative effect of any petroleum revenues on other parts of the Somaliland economy. Consequently the Minister submits a Bill for discussion by government with the aim of establishing the principles for use of any petroleum revenue.

2. Background

The State of the Republic of Somaliland ("Somaliland") has since before independence attracted investors to search for petroleum resources within the State's territory. The basis for this interest is similar geological features to that of neighbouring states, in particular that of Yemen, where commercial petroleum discoveries have been made.

Within Somaliland territory there are several places with oil seeps and presence of hydrocarbons have also been proven through exploration drilling in the past, but not in commercial quantities. Exploration activities have been carried out within Somaliland since the 1950's, but have regularly stopped due to the challenging security environment and the perception by several investors of so-called "political risk". Initially several major oil companies carried out exploration, since independence exploration has been carried out mainly by smaller oil companies.

Till date the upstream petroleum industry has only been governed through Petroleum Sharing Agreements between the investors and Somaliland. The Government has so far neither formulated a policy nor legislation for the upstream petroleum sector. The Minister recognises that some of the terms and conditions in the existing Production Sharing Agreements are not optimal seen from a regulatory and resource owner perspective. This policy and the draft upstream petroleum bill and petroleum revenue bill is meant to address some of these concerns. Unfortunately new legislation will only have effect on certain issues on some of the Petroleum Sharing Agreements for various legal reasons. This policy and the two bills will therefore primarily have affect for future petroleum activities.

The Minister hereby, in accordance with the overall legal and policy framework of Somaliland, presents to the government a draft policy for the upstream petroleum sector. If approved by the cabinet, this policy together with two Bills presented at the same time would be subjected to the Constitutional procedures for approval and passing into respectively formal policy and enacted Laws.

3. Purpose of this Policy Document

The Ministry's aim with this Upstream Petroleum Policy for Somaliland is to establish a governance tool for the upstream petroleum activity subject to Somaliland jurisdiction.

This document shall:

- Place this policy into the wider context of national policy and the Constitution
- Outline the general principles and policy for upstream petroleum activities

- Explain the defined scope and background for the general principles and policy
- Address specific policy issues pertinent to the upstream petroleum sector
- Clarify the interface with other policy and regulatory areas, in particular:
 - Health, Safety and (work) Environment (HSE) issues
 - Protection of the (external) environment and third party interests
 - Energy Policy
 - The mining sector
 - The mid- and downstream parts of the petroleum industry value chain.
- Serve as a reference for the application of policy through use of legislation and other tools available to government including use of transparency as tool, communication via media, enter into agreements, enter into dialogue with subjects concerned, establish economic incentives or disincentives, encourage private initiative, promoting public awareness and use of regulatory powers.
- Serve as a policy statement towards investors and third parties and thereby creating a transparent and predictable environment conducive to investments
- Establish a reference point for future policy decisions and adjustments.

4. The Context of this Policy

4.1 Introduction

The petroleum policy is drafted within the context of the Holy Quran, the Constitution and national, overarching policy documents as well as other applicable legislation. In addition the reasoning expressed in this policy document is well aligned with traditional approach to common goods and benefits in a Somaliland context.

4.2 The Constitution

According to article 12.4 and 12.5 of the Constitution:

"4. The central state is responsible for the natural resources of the country, and shall take all possible steps to explore and exploit all these resources which are available in the nation's land and sea. The protection and the best means of the exploitation of these natural resources shall be determined by law.

5. Where it is necessary to transfer the ownership or the benefits of a public asset, the transfer shall be effected in accordance with the law"

According to article 11 of the Constitution, private enterprise shall be one of the key components of the "national economy".

Furthermore it follows from article 18 of the Constitution that

"The state shall give a special priority to the protection and safeguarding of the environment, which is essential for the wellbeing of the society, and to the care of the natural resources. Therefore, the care of and (the combating of) the damage to the environment shall be determined by law."

4.3 National Policy Documents

The National Vision for Somaliland towards 2030 identifies that:

"Occurrences of oil and gas have been also confirmed. The geological structures of the country favor [sic.] the existence of commercial quantities in hydrocarbons. The government will provide appropriate legal framework and incentives to encourage the exploration and exploitation of the country's mineral wealth."

In the National Development Plan (2012-2016), the upstream petroleum sector is briefly addressed under the section addressing the "mining sector" and states in the situation analysis of chapter 5.1.7:

"Oil and gas show good prospects. Commercial development of oil is believed to be a realistic possibility based on the finding of oil in Yemen in similar geological formations. However, mining is presently limited to only quarrying in Somaliland. What is needed is a regulatory framework that attracts foreign investment, while safeguarding national interests."

4.4 Traditional Rules on Common Scarce Resources

Finally according to the traditions of the clans of Somaliland, common scarce resources like pastures and water resources have been managed to the benefit of all. Many of these principles should be possible to apply for the "herding" of petroleum resources as well.

5. Main objective of the Upstream Petroleum Policy

In line with the Holy Quran, the Constitution and other policy documents as referred to in part 4 above, the Ministry considers that the main goal of the upstream petroleum policy shall be to:

Manage the petroleum resources in a long-term perspective for the benefit of the whole society of Somaliland. As the petroleum resource is owned by the government on behalf of its people, it shall be optimally managed so that as much as possible of any petroleum is discovered and converted into economic assets which will allow for sustainable use in the economy and thereby contribute to ensuring welfare, employment and development within the State, while taking due regard to the environment, the people and third party interests. The State shall encourage use of private investors to lower own risk, while securing access to financial and technical competence.

6. Key Upstream Petroleum Policy Principles

The Ministry considers that Somaliland as owner of petroleum resources subject to Somaliland jurisdiction and in order to achieve the above stated main objective shall:

- Encourage exploration for petroleum through attracting qualified oil companies and other investors, providing access to area by returning areas without activity and by making petroleum data available as accessible as possible.
- Optimize recovery of petroleum resources to the benefit of Somaliland while keeping costs low having due regard to the external environment and HSE considerations.
- For environmental reasons and to avoid wasting a valuable resource ban flaring and cold ventilation of gas except for safety reasons and short test periods.
- Establish mechanism to benchmark performance of the oil companies.
- Transfer the value of the petroleum resource through optimized resource rent into lasting value and benefits to Somaliland without negatively affecting the existing economy.

- Encourage the development of Somaliland's own industrial base and economic sector through establishment of parameters that allow Somaliland legal entities to compete on equal basis.
- Require investors in upstream petroleum activities to be established with a qualified organisation in Somaliland and that such investor shall be responsible for all activities carried out by contractors and subcontractors.
- Establish and retain a predictable policy and regulatory regime for governing the upstream petroleum sector.
- Manage petroleum resources in a manner which demonstrates Somaliland's capacity to act as prudent sovereign nation state acting in accordance with international law.
- Promote and implement transparency in all parts of the upstream petroleum sector, including regarding any revenues from the sector.

7. Scope of the Upstream Petroleum Policy

7.1 Introduction

In this part the Minister will describe the scope of its upstream petroleum policy and the two bills drafted as a consequence. The government is responsible for defining the scope of application of the policy and the two bills.

Many nation states have decided to treat petroleum in the similar manner as (hard) minerals. The Minister will argue that conventional petroleum must be addressed differently than minerals.

Furthermore, as the Minister responsible also for Energy, it is important to emphasize that I recommend not using of any petroleum discovered in Somaliland as a dedicated source of energy for Somaliland except for in emergency situations.

To understand the reasoning behind all the three elements above, it is necessary first to understand and recognise certain particularities regarding petroleum trapped in the earth's crust.

7.2 Characteristics of petroleum

Petroleum in its natural state consists of hydrocarbons varying from heavy oil to gaseous substances depending on temperature and pressure. Petroleum may also be solid in its original state such as bitumen and tars. This policy and the corresponding bills do not address the so-called non-conventional petroleum resources.

When excluding the solids, an important characteristic of liquid and gaseous petroleum is easily identifiable, it may fluctuate or migrate.

In addition petroleum in the ground is normally under pressure.

Offshore the natural occurring pressure in the reservoir is the main force allowing petroleum to be produced up to the surface. The natural pressure may be enhanced through various methods of injecting liquids and gas into the reservoir. Loss of reservoir pressure thus results in stop in flow of petroleum. Managing the reservoir pressure is thus an essential part of managing the petroleum resource.

Onshore, in addition to use of pressure, various mechanical pump mechanisms may be employed. The most known of these methods is rod pump; however this technology is not suitable for large volumes or offshore.

A key characteristic of petroleum is that it is a finite resource. This implies that the revenue generated from petroleum will not be lasting and the revenue generated from such a resource cannot be seen as sustainable in itself. From a different angle the characteristic that reservoir pressure is important combined with the resource is finite, implies that few mistakes can be afforded when deciding the manner of extracting the petroleum in a reservoir.

The petroleum products refined from the crude oils is the single most important energy source for use in various combustion engines from motor-bikes to airplanes. It is estimated that worldwide more than 60 % of petroleum consumption is used for transportation purposes. Due to this and other usage, petroleum must be expected to remain in demand in the world market for the foreseeable future. However, as for any commodities and products, the price depends on supply and demand. In addition the petroleum world market is more susceptible to non-market influences as there are relatively few exporting nations and several of these are willing to use the supply situation to achieve political goals from time to time. The effect is that petroleum prices tend to be volatile over time.

The volatility of the petroleum price is a key concern with regards to any future State revenue from the sector. If petroleum discoveries are made, the negative effects of volatile prices on what would constitute possibly a very significant source of revenue needs to be addressed by this policy, see below for further on this challenge. To mitigate these perceived negative effects, is one of the reasons the Minister submits for discussion the Petroleum Revenue Bill.

Finally, petroleum is often understood to also refer to refined products. In the context of this policy this is not the case, petroleum is meant to include crude oils and gas as extracted from the wellhead.

7.3 The Petroleum value chain

As for most industries one may divide the petroleum sector into different parts of a value or supply chain. Which terminology is used depends on the definition; in the following petroleum value chain will be used.

There are many ways of describing value chains. For the purpose of this policy it suffices to refer to chains that start with obtaining raw material that ultimately is used to manufacture goods for consumers, industry or other customers purchasing the manufactured output (may be finished or semi-finished). Such a chain in its simplest form will consist of at least the following elements: (1) obtaining raw material(s), (2) transportation of raw material to manufacturing entities and (3) manufacturing the products and finally (4) distributing products to customers.

Traditionally the petroleum supply chain has been segmented into "upstream" and "downstream" and in between the two segments it is not uncommon to also include "midstream".

What is understood by the different segments of the chain varies, but the Ministry considers that the following description roughly represents general industry understanding:

- a) Upstream - all activities related to discovering and extracting petroleum, generally referred to as exploration and production. Compared to the supply chain, exploration and production can be seen as part of obtaining raw material
- b) Midstream is typically used to refer to the transportation of petroleum from any production entity to a defined delivery point and in relation to the supply chain can be seen as part of the logistics part bringing the raw material(s) to the next part of the supply chain.
- c) Downstream is a term typically used to refer to the process of decomposing petroleum into a multitude of products (petrol, plastics etc.), as well as distribution of such products through wholesale and retail

As indicated by the title of this document, the Ministry in this Policy only intends to address the upstream segment of the petroleum supply chain.

In the draft Upstream Petroleum Bill the Ministry has defined "petroleum activities" to mean

"planning, preparation, installation and execution of all activities associated with petroleum reservoirs, including reconnaissance, exploration, development, production, transportation and decommissioning"

Several of the words included in the definition are defined further in the Bill. Here it suffices to point to that the definition covers all the phases of traditional "exploration and production" including decommissioning. The definition of "petroleum activities" covers all traditional upstream elements, but does also include transportation. It follows from a further definition in the Upstream Bill, that only transportation by pipeline is included.

With the above definition the Upstream Petroleum Law will apply up to the point of delivery where there is more than one offtake possibility. In the most likely scenarios for Somaliland the applicability of the Upstream Petroleum Law would therefore be up to the shipping point on the coast for onshore and offshore reservoirs or alternatively for offshore at the shipping point directly from the production facilities (such as platforms, FPSOs and more).

Refining of petroleum is an industrial activity, raw material enters one end and products come out the other. The Minister notes that the refinery business is not very profitable compared to other industries, and certainly not compared to the revenue which may be obtained by the State from extraction of petroleum resources. In several cases where nation states have become petroleum producers, governments have decided to invest in refineries considering that the government should organise themselves the same way many major oil companies used to do; i.e. vertically. This Minister considers this to be the wrong approach as proven by a range of government sponsored refineries generating losses rather than any additional revenue.

The same may be stated regarding distribution and retail of petroleum products such as petrol and oil products to consumers. The development has been clear for some time the margins on selling petroleum from petrol stations etc. are continuously under pressure and revenues are often generated from selling other products using petrol primarily to attract consumers on the go. The Minister notes that several oil companies have divested their interest in downstream activities.

The significant value creation thus relates to the upstream petroleum sector. Ultimately which elements of the petroleum value chain are to be covered by this policy is a question of which definition is used.

Therefore based on the experience from a variety of jurisdictions, the Ministry intends that this policy, and legislation drafted in accordance with it, shall only address the upstream part of the petroleum sector as defined above. Most (mid-) and downstream elements should be subject to other generic legislation regarding industrial plants, area planning, product quality etc. The main exception to this would be Health, Safety and Environmental (HSE) issues, the HSE regulation for land based petroleum facilities within the upstream segment may as a general rule also be made applicable to the (mid-) and downstream segment.

7.4 Resource Management Policy versus Energy Policy

The Ministry is also responsible for energy. This policy document does not concern energy policy as such. It addresses the management of a finite resource.

Any nation state at any stage of development and at any time in history will need energy for a range of purposes. When this Minister thus establishes policy or law addressing energy, it is with the view of securing energy supply for the needs of the State and its subjects. The sources of energy will normally be regulated to a large degree by the market through demand and supply. However, government may seek to influence use of one type of energy source over another and also encourage or participate in

energy generating projects requiring substantial investments such as hydroelectric plants, combustion base power centrals etc.

Petroleum is also a source of energy, but the discovery of own petroleum should not influence the Energy Policy as such. The only circumstance where this main principle should not apply is in the case of an emergency situation where the only source of energy would be domestically produced petroleum. The Minister has recognized that such exceptionally circumstances may occur and have included a provision in section 40 to cater for such an eventuality.

7.5 Petroleum activities Offshore versus Onshore

The petroleum potential in Somaliland is considered by several investors to be both onshore and offshore.

There are some significant differences between petroleum activities carried out offshore versus onshore.

Firstly the legal basis for petroleum activities onshore is different from offshore.

Within the territory and the territorial waters a nation state exercises sovereignty. Beyond the territorial waters offshore international law only provides that a coastal state may exercise sovereign rights over its part of the continental shelf.

The difference between sovereignty and sovereign rights is important to understand as it affects what a nation state may or may not exercise of authority over legal subjects depending on where the activity is carried out.

Roughly one may express that sovereignty provides the nation state's government with authority concerning any issue which does not contravene international law. For sovereign rights the nation state's government may only exercise the type of authority allowed by international law.

An important consequence of the content of the two legal terms is that laws which apply to "Somaliland" or the "territory of Somaliland" and similar descriptions will not apply on the continental shelf automatically.

For the purposes of this policy it suffices to state that it follows from international law that a coastal state may enact legislation required to govern upstream petroleum activities. The coastal state should carefully consider which parts of existing legislation or new legislation should and may be made applicable for petroleum activities on the continental shelf.

It is also important that a sovereign coastal state is aware of the international obligations established in relation to petroleum activities. If a government fails to implement proper measures to manage and survey the petroleum activities, the nation state itself may be held liable by other nation states for any incidents or accidents. See in particular United Nations Convention on the Law ("UNCLOS") of the Seas Part XII, section 1.

Secondly there are important differences between offshore and onshore regarding cost factors. Exploration in the form of seismic surveys is considered as a rule of thumb to be about 10 times more costly per line-kilometre than offshore. Whereas drilling offshore (both exploration and production wells) is normally significantly more expensive than for onshore.

Another important difference is that on land important considerations have to be made towards the owners and users of land areas where petroleum activities are contemplated.

With regards to Health, Safety and Environmental concerns there is also a notable difference between offshore and onshore activities. Offshore on facilities, installations or structures space is limited and weight and separation of production equipment from living quarters for instance become important

and the same with regards to structural integrity. Onshore it is easy to separate for instance living quarters from the production facilities.

Finally with regards to the natural environment the potential for liquid pollutants (i.e. in particular oil) to affect larger areas is much more present offshore than onshore (unless close to waterways). In general terms it is easier and cheaper to contain liquid and solid pollutants onshore than offshore.

8. Particular considerations for Somaliland

8.1 Coordination with other ministries affected

The upstream petroleum sector does not affect only activities subject to the proposed Upstream Petroleum Bill or the portfolio of the Minister.

For the Petroleum Revenue Bill, the Minister invites the Minister of Finance to be the joint sponsor of the Bill and proposes that the Ministry of Finance be the government institution responsible for implementation of the enacted Bill together with the Central Bank of Somaliland.

Petroleum activities also have interface with other parts of the general legislative framework of Somaliland and the corresponding Ministries responsible for such areas. This applies in particular to:

- Labour working conditions and the employee work conditions subject to the ministry responsible for labour.
- Discharges, pollutants and effluents part of the portfolio of the ministry responsible for the external environment.
- Relationship with foreign nation states (see below for more on this) subject to the Ministry of Affairs, in particular in relation to activities on the continental shelf.
- For enforcement of provisions in the law, verification that the Bills are conforms with Somaliland legal tradition and for translation, the Ministry of Justice.
- Somaliland authorities responsible for emergency preparedness and protection against deliberate attacks, civil unrest or protection against ordinary crime.
- The government entity entities responsible for regulating use of land and for other livelihoods and economic activities (such as farming, herding of animals, other industries and mining) or use of the offshore (such as fisheries and mining).
- The government entity responsible for local government.

To the extent possible and agreeable to the relevant Ministries and government entities, the Minister proposes that the main point of contact for such other areas shall be the Minister. This is a proposition that may change over time as more capacity is obtained within other government institution. The Minister also considers that a "one-stop shop" approach will be considered positively by potential investors.

All of the above institutions will also be required to review applicable legislation with a view to alter it in order to be in line with the two Bills once enacted.

8.2 Human resources

The oil and gas business is a technology driven international business which requires investors with substantial financial and technical capacity. The industry also has the potential to impact the national economy as well as the external environment in a range of ways. It is not possible to govern this sector without qualified manpower available to government. This upstream petroleum policy and the draft legal framework meet only part of the requirements for governing the sector. Without qualified manpower within government, the effect of such documents will be very limited.

The Minister therefore proposes that the cost of establishing a minimum staff be covered through an annual petroleum administration fee which should be calculated based on actual costs. A provision (section 69 (5)) has been included to provide for such fee and details for its calculation shall be stipulated in regulations. Furthermore supervisory activities carried out by government may be charged to the licensee or contractor. The latter approach is used also in countries with sound national economy like Norway. The Minister recognises the potential for abuse of such an arrangement, but will seek to address this through detailed regulations.

The Minister intends, as policy, to keep the manning to a minimum as long as no commercial discoveries have been made. The plan is to both employ some key positions, while hiring diaspora and consultants for particular areas not currently in need of full-time presence within the Ministry.

As part of the obligations stipulated in the Upstream Petroleum Bill, the new employees should have access to training sessions arranged by the licensee or contractor.

The Minister intends to establish strict disclosure requirements for any persons working on his behalf and currently plans to include this in contracts with employees and contractors, but is also contemplating to include such requirements in the law or regulations. The disclosure requirements should cover any revenue obtained by said person before starting work and on a regular basis thereafter, as well as disclosure of any conflict of interest situation.

8.3 Mitigating expectations

Before petroleum is discovered in a virgin area (green field) the expectations of people living there tends to be that of curiosity to the new types of activities going on such as exploration drilling and seismic vehicles. If offshore, there is often not much visible activity for the population at all.

Often the interest from the general public has been limited before any commercial discoveries have been made. People tend to be public regarding the chances of achieving "sudden wealth". However, following commercial discoveries, experience from other countries show that expectations tend to go very high very fast.

The Ministry therefore advises that the Government in cooperation with industry establish a phased public campaign approach aiming at mitigating negative impacts of potentially high expectations.

8.4 Access to world markets

The maximum distance from the borders of Somaliland to the major sea port is in the range of up to 300 km and major sea lanes along the coast. It is expected that this geographical fact will provide easy access to the world markets for any produced petroleum. As pointed to in 9-3 below, a key policy point for this government is to sell or encourage companies to sell any petroleum to the highest possible price on the world market. Revenues which would then accumulate from such policy approach will then be either set aside in the Petroleum fund for long-term use, and a part of the income of the fund or even parts of the fund would then support the budget of government.

8.5 Foreign Policy

Somaliland is in a challenging situation with regards to international recognition. The Minister is aware of claims from pre-independence companies to areas currently subject to Somaliland's de facto jurisdiction. However, these claims are no longer considered valid.

Of greater concern for the Minister are the contemplated petroleum activities offshore.

The legal basis for exploitation of natural resources on the continental shelf is stated in the United Nations Convention of the Law of the Sea (UNCLOS) which is also considered to reflect international customary law to a large extent and thus binding for any nation state.

According to Article 77 of UNCLOS:

1. *The coastal State exercises over the continental shelf sovereign rights for the purpose of exploring it and exploiting its natural resources.*
2. *The rights referred to in paragraph 1 are exclusive in the sense that if the coastal State does not explore the continental shelf or exploit its natural resources, no one may undertake these activities without the express consent of the coastal State.*
3. *The rights of the coastal State over the continental shelf do not depend on occupation, effective or notional, or on any express proclamation.*

Before opening areas for petroleum activities offshore, the Minister requests clarification from the Ministry of Foreign Affairs as to the implications of the above provision in relation Somaliland's formal status and that of the overlapping claim from Somalia.

The Minister also requests that the Ministry of Foreign Affairs consider all pertinent legal issues before the opening of the State continental shelf for petroleum activities. Including, but not limited to, revision of current legislation¹ regarding the continental shelf, possible other overlapping claims with neighbouring countries, state responsibility, interface with UNCLOS (see in particular part VI), possible implementation of other relevant regional or international treaties and questions pertaining to state responsibility versus personal responsibility for cabinet members and others for decisions made.

Furthermore the Minister requests the Ministry of Foreign Affairs an overview of international treaties which should be considered when finalising this policy and the two bills.

9. Policy topics regarding the upstream petroleum sector

9.1 *The Characteristics of Petroleum relevant for legislation*

Above certain characteristics regarding petroleum on a broader level where addressed.

In the following petroleum also means oil and gas in liquid or gaseous form and which considerations should made to this effect in the Upstream Petroleum Bill and Petroleum Revenue Management Bill.

As mentioned it must be understood that petroleum in the ground is a finite resource. Any commercial discoveries will only last for a limited time span. It is therefore important that government as resource owner is involved in all major decision gates. In the current PSAs, the government has limited influence over key aspects of the decisions made by the companies up to and after production starts. The Minister wishes to rectify this and has included provisions in the Upstream Petroleum Bill which requires the Minister to approve the field development plans submitted by the contractors, see sections 28 and 29 of the Bill.

In the same spirit of the government's legitimate interest to ensure optimal recovery of petroleum, the plan for production should be approved on a regular basis. The Minister considers that annual applications for production are sufficient, see upstream petroleum bill section 32. The main purpose of this provision is to encourage the oil companies to continuously search ways to improve the total recovery rate from the reservoir. When applying for a production permit, the Minister will consider if such efforts have been sufficiently considered.

Another implication is that any revenue obtained from petroleum will be for a limited time. It should also be understood that the price of petroleum is volatile and depends on a range of factors influencing world market prices. Any revenue from petroleum would thus have the characteristics of not being sustainable and susceptible of being volatile. Both characteristics are undesired for incorporation in a

¹ See Law No. 37 on The Territorial Sea and Ports, of 10 September 1972

national budget. The Petroleum Revenue Bill therefor provides in broad terms that all petroleum revenue is to be transferred to the State and use of the petroleum fund may only be allowed according to a set of principles aiming at mitigating the negative effect of the petrol revenue. A chart showing how the Petroleum Revenue Bill will organise any revenue flow is attached as appendix 1.

Petroleum will not be discovered unless it is searched for, and despite all technological developments, discoveries may currently only be made with drilling (exploration drilling). The basis for drilling will almost always be other geological reconnaissance, of which acquisition of seismic data is the most important. Such activities should be encouraged by the State; else no resources can be discovered. The Minister has thus decided to allow non-exclusive reconnaissance against receiving copy of the data for internal government use, see Upstream Petroleum Bill part III. In this part, section 15 allows for exclusive reconnaissance license. This is meant to be an exemption from the main rule in case no company undertakes to carry out non-exclusive exploration onshore. The background for this differentiation is that costs for exploration offshore are roughly 1/10 of costs for similar size area onshore.

Petroleum in its traditional form migrates (or moves) through any reservoir (for image purposes think of a sponge underground) this has implications on legislation as it must cater for this characteristic (as opposed to minerals). Thus it should be catered for this characteristic of petroleum in relation to any reservoir extending into areas beyond the area awarded to the investor(s) in question. The Minister therefore recommends including regulation of unitisation of agreement areas covering the same reservoir in section 34 of the upstream petroleum bill.

Not only may a reservoir extend beyond an agreement area, but also into an area subject to the jurisdiction of another nation state. Such situation must be regulated by treaty between the two nation states in question. Several examples of such international trans-boundary unitisation treaties are publically available and may serve as examples as required. However, such treaties typically entail allowing civil servants from another nation state exercising limited regulatory functions within the area subject to the other country's jurisdiction. To provide for this the Minister recommends including a provision granting immunity for such civil servants carrying out there functions, see section 24 (5) of the upstream petroleum bill.

Similarly Petroleum underground is normally under pressure and may also have high temperatures. This has important implications on safety and prevention of unwanted incidents and accidents. The further requirements in this regard is susceptible to changes in technology, thus the Minister considers this a subject for the regulations.

Petroleum extracted at the wellhead may also have many different characteristics and consist of a variety of components, including other valuable elements such as helium. The Minister is aware that there in particular helium has been a contentious issue in other jurisdictions. The Minister therefore advised to mitigate any such issue by defining petroleum to mean:

"crude oil, natural gas or any naturally occurring liquid or gaseous hydrocarbons existing in the subsoil as well as any other substances produced in association with such hydrocarbons".

To ensure proper understanding the reference to "naturally occurring" excludes refined products such as petrol and fuel for vehicles and crafts.

This definition includes any other components of the well stream as extracted at a wellhead under the scope of the upstream petroleum bill. This must be seen as a safety feature to avoid giving away any valuable resource which one would not be aware of before discovered in a well stream, the Minister may then negotiate separately any terms and conditions regarding additional components of the well stream or at least be guaranteed a revenue equal to that which applies for the hydrocarbons.

9.2 Gas versus oil

As noted "petroleum" is meant to include gas and oil, some remarks regarding the difference is still required from a policy point of view.

Of the petroleum extracted at the well head, crude oil is generally the part most easily sold on the world market. In addition oil is often fairly easy to transport, although this depends on the quality of petroleum and the distance to any shipping point.

Gas requires and offtake through either pipelines or through various approach of liquefaction for transport elsewhere. Establishing a local market for supply of gas for energy consumption requires substantial ability to finance such an undertaking and willingness in the local market to pay the price for the gas when the capital expenditure has been included in the cost.

For liquefaction of gas, substantial investments would have been made. Normally such investments require a substantial resource base.

In both cases obtaining the buy-in from the oil companies may prove difficult.

In addition the investor is also aware that production of gas normally is capped at maximum level from one year to the other, thus companies seeking quick return on the investment are normally not in a position to peek production early as they may do with oil.

It is still the intention of this Minister to avoid waste of the petroleum resource. If viable and economical ways of commercialising the gas cannot be found, the gas shall always be considered for reinjection to maintain reservoir pressure or for utilisation for energy production at the production facilities. Flaring and cold ventilation shall not be permissible without the express consent from the Minister and the intent is not to allow for this except for in exceptional circumstances, see section 36 of the upstream petroleum bill.

Often solutions for establishing a commercial basis for the sale of gas may be achievable if several reservoir subject to two or more exploration and production sharing agreements must be developed jointly to achieve a desirable solution seen from the government's perspective as resource owner. A joint development may often reduce the total costs compared to two or more individual developments. Therefore the Minister has proposed to include both provisions for joint petroleum operations allowing the Minister to require the contractors to propose solutions covering several agreement areas.

In the case that a gas (and/or oil) discovery may become more economical or may only be developed if allowed to connect to existing or planned facilities belonging to third party contractors, the Minister should have the authority to require other contractors to provide third party access on terms and conditions that can ultimately also be stipulated by the Minister if agreement is not reached voluntary, see section 38 of the upstream petroleum bill.

9.3 Non-Subsidy policy

Somaliland as the resource owner of petroleum should focus on maximising the value of the extracted volumes. This implies selling Somaliland's part of production split to the highest market prices in the international market. Sale locally should consequently only be made if the highest price (but typically excluding transportation costs) may be obtained.

Many petroleum producing countries (including Indonesia, Peru, Venezuela, Iran, Sudan to name a few) have made the fundamental mistake of "sharing" the benefit of "free" or "cheap" petroleum with the population. This has cost these nations dearly. The impact of such policy becomes particularly visible when "cheap" domestically supplied petroleum is no longer available and petroleum must be bought on the world market and sold to subsidized prices.

Furthermore such subsidies will benefit those that can afford a motorbike other vehicles. Those in most need would not be able to afford such items, thus fuel subsidies do not really reach out to those most need. In addition low prices stimulate consumptions amongst those that have money, negatively affecting government's revenues and the environment through increased emissions at the same time.

The Minister therefore recommends not subsidizing petroleum products to the population if discoveries are made. The Minister instead intends to maximize revenues from any petroleum through sale at the highest obtainable price in the international market and thereafter use the mechanisms in the petroleum revenue bill to ensure proper management of such revenue in a long-term sustainable manner.

This policy of non-subsidy is not expressed in the bills as such, but follows from the application of a resource management perspective and the principle of sustainable revenue management as implied in the two bills.

9.4 Somaliland as Resource Owner

The Ministry considers it fundamental for the understanding this policy document that Somaliland is the owner of the petroleum resource. In the following this role of Somaliland will be referred to as the resource owner.

It follows from the Somaliland Constitution that the owner of petroleum in its original state (i.e. before extracted from a reservoir) is that of the nation state. This is a conscious choice by government and when Somaliland is the owner of a valuable resource, the government has a duty on behalf of the people to steward this resource optimally for the benefit of all. Thus Somaliland is not only acting as a government regulating the sector, but Somaliland has a role as the owner of the petroleum resources.

The ownership of something by the nation state versus the ownership by for instance a private company should fundamentally imply the same; both would and should be interested in maximizing the value of the resource for their own benefit. Consequently if Somaliland takes measures to maximize government revenue from a resource it owns, it is doing the same as what any other owner would be expected to do.

Many oil companies try to argue that the upstream petroleum sector should be treated as any other industry. "Leave it to the companies". What the oil companies then leave out is that petroleum production normally includes a sizable element of profit that stems from the resource itself and not because of the economic activity carried out by the company.

As a resource owner maximizing the revenue means securing as much of the resource value as possible, while still being able to attract investors (oil companies) to do the job. The investors bring capital, people, technology and experience into the projects. All these elements are required to successfully discover and develop petroleum reservoirs and, at least for the time being, the Government have very limited capacity within all the mentioned elements. As far as possible win-win approaches between Somaliland and the investor should be sought. So that if the investors manage to increase the total recovery rate from a reservoir, then the investor should also benefit together with the resource owner.

One could easily think that it does not really matter if ownership of a resource is on private hands or public hands; i.e. that interest would be concurrent. This is not the case, and also should have influence on how the legal framework is designed. Governments typically operate with an internal rate of return of between 3-4 %. The private sector upstream petroleum sector typically operates with an internal rate of return of between 10 – 15 %.

In almost all cases the extraction of a petroleum reservoir benefits from a slower rather than a fast extraction rate if the aim is to recover as much resources as possible.

Due to the difference in internal rate of return between governments and private investors, the governments generally should focus on total recovery rate over time. Whereas the investors tend to be looking for the quickest return on investment so the company can move on to new projects. Thus the investors more often than not are interested in producing as much petroleum as possible in a short time span which normally means more petroleum risks being left in the ground.

The upstream petroleum bill is therefore designed to provide Somaliland with the tools to ensure optimal recovery seen from the resource owner perspective. The most important decision affecting the recovery rate is, as mentioned above, the chosen solution for developing a reservoir in preparation for production. In the existing Production Sharing Agreements, government in reality has very little influence on this decision gates as indicated above the Minister intends for this to change.

9.5 Encouraging private investment while capturing resource rent

Having pointed to the importance of the role of Somaliland as the resource owner, one must also consider and recognize the importance of the role of private investment in order to discover and produce the petroleum.

Somaliland believes in a free economy and in private initiative. Investors that have the necessary skills, experience, equipment and capital should be encourage and welcomed to assist in the resource owner's (Somaliland's) endeavours to discover and hopefully produce petroleum resources.

The most important benefit the investors will seek is a share of the petroleum produced. In addition the investor will consider a range of issues before making an investment decision, of which the fiscal and economic terms are typically the most important.

There are many approaches to capturing resource rent. It is the view of the Minister that the capture shall be based on a production split model using a so-called R-factor calculation to cater for fluctuations in cost levels and prices. This allows creating a balanced and fair approach to capturing the resource rent.

In addition the Minister intends to review whether other taxes should be made applicable which are currently excluded due to grandfathering provisions. In particular the Minister will assess capital gains tax for profits generate from the sale and purchase of shares in a PSA and withholding tax. The Upstream Petroleum Bill provides for royalty, bonuses and production sharing (which would include an R-factor approach), whereas the mentioned taxes would have to be addressed in appropriate tax legislation.

Private investors, in particular oil companies, have a very long term perspective on their investments. Typically exploration and development will take between 4 to 10 years depending if it is onshore or offshore and other factors, whereas the production period is typically anywhere between 10 to 30 years with the possibility of renewal. The exploration and development phase accumulate substantial costs that investor have a legitimate concern about being able to recover.

For this reason most investors will seek to "lock in" the fiscal and economic terms so that government may not adjust these elements for the duration of the agreement awarding exclusive petroleum rights.

Although the Minister recognises that "grandfathering" (i.e. locking the terms and conditions) changes the relation between the Government and the company to a contractual relationship with substantially reduced possibility to exercise sovereignty or sovereign rights, the Minister also recognises the concerns of the oil companies. The Minister will therefor continue to use agreements as the primary mechanism to award exclusive rights for exploration and production to the companies.

However, the Minister does not see the need for "grandfathering" to apply all sides of the relationship between the two parties. For this reason it is the intention of the Minister to reduce the elements covered in the exploration and production sharing agreement to certain aspects that will always have to

be individualised (for instance the parties, the area awarded, the operator, the minimum work obligation, special environmental conditions etc.) with the addition of "grandfathered" economic and fiscal terms. For other areas, the main regulation of the sector shall be based on the proposed upstream petroleum bill and regulations pursuant to it. See sections 20 and 21.

9.6 Data and acreage management

The most important factor in attracting foreign investors is the perceived prospectivity of a petroleum province. The prospectivity of an area will be influence depending on the latest information available.

Geoscientists will use geo-scientific knowledge to assess the basic geology for discovering petroleum before deciding on which areas should be subjected to further exploration activities. Through different geoscience activities, but in particular through seismic surveys offshore or onshore, further geoscience data are obtained. Such geoscience data allows geoscientist to establish if there may be possible source rock (where oil and gas may have been "made"), if there is a reservoir rock (that is rock with sufficient permeability and porosity for petroleum to flow through when extracted and if there is a petroleum trap hindering the petroleum to find its way to the service by its own.

For Somaliland it suffices to establish that the prospectivity currently is high enough that some investors have decided to carry out exploration.

An important way of achieving more discoveries is to explore more to improve understanding of relevant geology through more data.

But in addition it is important that the information be made available and accessible so that investors may interpret the information and thereby optimise use of limited funds available for exploration drilling. The importance of having different investors with different ideas looking at geological data cannot be sufficiently underlined. Geo-science with regard to interpreting data is qualified guesswork and requires imagination and willingness to consider different models, normally referred to as "plays". Essentially it should be the ultimate goal of a resource owner, that as many geo-scientist in the world look at available data to ensure that no "play" is left unthought-of.

In some cases investors will carry out seismic surveys without requiring production rights. Such surveys are typically carried out by seismic companies on speculative basis. The business model is based on acquiring data and then selling data packages on a multi-client basis (the same data sold to several companies). Normally the costs are recovered if two or three multi-client licenses have been sold. The Minister considers such speculative surveys to be beneficial for the State provided that a data set is provided to the Government for free.

The Minister acknowledges that receiving data for free implies that the data must be kept confidential till the seismic company has managed to recuperate the initial costs. Other than in this circumstance, it is the view of the Minister that data acquired should be available to interested parties as soon as possible. The details concerning the duration of confidentiality in different circumstances may need adjustment from time to time, and will thus be specified in regulations.

Data does not suffice if areas are not available for investors to carry out reconnaissance or exploration activities. The Minster therefore proposes mechanisms that ensure or encourage the oil companies to return awarded areas not subjected to any petroleum activity. To accentuate this further the Minister propose that as a principle the area fee shall provide (negative) incentives against retaining agreement areas not being subjected to petroleum activities, whereas areas subjected to petroleum activities will be exempt from area fee in its entirety.

Given that the companies currently have exclusive rights to quite sizable areas the Minister proposes that the size of the agreement areas are reduced to between 500 square kilometre and 2500 square kilometres depending on various circumstances. The Minister therefore proposes to reduce the size of agreement areas compare to the size awarded to day (up to 12 000 square kilometres).

The Minister as a policy goal will also seek to promote and if attractiveness of Somaliland's petroleum provinces increases following commercial discoveries, push for there being between three to five contractors in one exploration and production sharing agreement established in an unincorporated joint venture. This approach will allow the Minister to benchmark performance, establish checks and balances with regard to the operator (the other parties to the unincorporated joint venture will monitor every aspect of the operator's activities and spending), provide for plurality of ideas within the group, spread risk, bring in competence which should ideally complement each other and more financial capacity.

In order achieve the desired effects described immediately above to work, the Minister will aim to introduce as an absolute requirement that contractors should be an independent oil company with personnel competent in geo-sciences, with relevant technical and HSE expertise and sufficient financial strength. The Minister has proposed to include these contractor requirements in the upstream petroleum bill, see section 69.

9.7 National Oil Company

Many nation states seem to consider the creation of National Oil Companies to be a vehicle for better control of the petroleum sector.

Somaliland does currently not even have the staff required to fill the posts in public authorities that should be in charge of overseeing the upstream petroleum sector. Establishing a National Oil Company risks cannibalising on the very few human resources Somaliland has for this purpose.

In some countries it seems that National Oil Companies have in fact become states within the states due to lack of proper checks and balances.

The Minister has carefully assessed the need to establish a separate National Oil Company and concluded that the idea is not supported by this Minister. Should substantial discoveries be made at a certain stage, the Minister will reconsider the matter provided it will not affect the State's ability to properly govern the upstream petroleum sector.

Should there be substantial discoveries; the Minister proposes to include a provision which allows the Minister to send a substantiated request to the Parliament for funds and approval for incorporation of a National Oil Company. See the upstream petroleum bill section 9 (3).

9.8 National content

Many nation states have attempted to force national content upon investors. This has more often than not backfired and created unhealthy agency cultures not conducive to the interest of the nation state as the resource owner. The Minister considers that national content should be pushed only where it does not compromise health, safety and environmental aspects. Therefore the investor is required to hire Somaliland nationals for activities not requiring any skills and otherwise employment of nationals is stipulated as a general goal. See the upstream petroleum bill section 68 (1) and (2).

The Minister considers the requirement to establish an office with qualified manning for companies having been awarded an exploration and production sharing agreement will have positive repercussions for the community affected.

In addition the Minister plans to include provisions in secondary legislation requiring publication of tenders in local media. The Minister is also considering a requirement that all contracts entered into within the upstream petroleum activities shall be subject to Somaliland law. The consequence of such a proposal needs to be discussed further.

Finally national goods and services are to be given preference if equal in quality in compliance with HSE requirement, see upstream petroleum bill section 68 (4).

9.9 Avoiding the resource curse

For politicians and the population alike, any discovery of valuable resources is bound to be perceived positively and as a blessing. The experience of countries with weak governance structures mixed with discoveries of valuable resources, however, has more often than not been negative.

Both industrialised and developing countries have managed natural resources and revenues from it in a manner which has not benefitted the economies of the countries. The experience from most resource rich developing countries has been even worse. In a World Bank report² the resource curse is described to typically include the following elements:

- (a) currency appreciation that can reduce the competitiveness of nonextractive exports*
- (b) more difficult macroeconomic management due to volatile commodity prices,*
- (c) inefficient management of the extractive sector,*
- (d) corruption and serious political conflicts over rent capture and management of revenues generated by the extractive sector, and*
- (e) dissipation of rents on current consumption rather than investment.*

The most common mistake concerns how the petroleum resources and revenues generated from such resources are managed by the resource owner (i.e. in most cases nation states and their governments).

As earlier indicated the Petroleum Revenue Bill is intended to address all of the above concerns.

The Bill provides for transparency regarding receipt and use of petroleum revenue. Furthermore the Bill allows use of funds to develop Somaliland, but such use shall pass the test that the investment is likely to provide lasting, sustainable value for the nation state.

Several nation states have joined and become compliant with the Extractive Industries Transparency Industries (EITI) standards for reporting of petroleum revenue. The Minister at this stage considers participating in EITI is not required and that focus should be on the implementation of the Petroleum Revenue Bill.

9.10 Health, Safety and (work) Environment

Health, Safety and Environment (HSE) are important subject matters. It shall be the policy of this Minister that regulation in this regard shall not be subject to any "grandfathering" provision.

Otherwise the Minister envisages that HSE shall be based on a functional approach rather than descriptive approach. Following the Macondo-accident in the Gulf of Mexico, this seems to be the prevailing tendency. The Minister recognises that this approach may be somewhat demanding, but considers it to be the way forward.

There are relatively few articles directly addressing HSE in the Upstream Petroleum Bill, but one key provision is the proposed "see-to" requirement for contractors and licensees see section 65 of the Bill. Such approach implies that the possibility for "blame-game" is significantly reduced. The responsibility remains always at the "top".

Much of the HSE provisions will therefore be regulated in regulations pursuant to the enacted Bill. This work also requires careful coordination with legislation and institutions with oversight of issues closely related to HSE within the upstream petroleum sector. Furthermore, as indicated above, delineation of responsibility with other Ministries responsible for labour, health and safety issues must be established. It may also be that existing legislation shall be made applicable for the sector.

² The Changing Wealth of Nations, Measuring Sustainable Development in the New Millennium, World Bank 2011

9.11 The external environment

Large parts of Somaliland consist of fragile ecosystems. Somaliland is committed to protection the environment and biodiversity.

Currently Somaliland does not have the capacity to carry out full-fledged strategic environmental assessment as provided for in the upstream petroleum bill section 11. To mitigate this situation the Minister proposes to have the possibility to require companies to carry out all or only elements of a full-fledged strategic environmental assessment, see section 11 (3). The Minister plans to stipulate detailed requirements with this regard in invitation to bid or in the license or exploration and production sharing agreement.

The Minister intends to work closely with the Ministry responsible for the external environment to establish a proper legal framework aiming at protecting the environment from potential harmful effects of petroleum activities. The Minister supports the following key principles in order to protect the environment; polluter pays, use of best available technology, sustainable development, the precautionary approach and the aim of continuous improvement. To the extent these principles are not reflected in existing legislation, the Minister together with the Ministry responsible for the external environment will establish a separate project with a view to update the environmental legislation to cater for the challenges brought by petroleum activities.

DRAFT

Appendix 1

Cash flow under Petroleum Revenue Management Bill

