NORWEGIAN PETROLEUM DIRECTORATE

Petroleum Fiscal Systems

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Outline

- Finding the “right” fiscal system
  - Introduction
  - Taxation in Norway
  - Production Sharing Agreements (PSA)
  - Comparisons

The fiscal policy
Objective

- Government objective
  - Maximise Government take

    Get as high share of the profit as possible

  - Maximise value of the petroleum resources

The goal is to create a win-win situations between the state and the oil companies

- Companies objective
  - Maximise shareholders interest (private or public)

The fiscal policy
Challenge

- The challenge of the fiscal policy:
  - Ensure as high share of the value as possible for the Government
  - Encouraging the exploration and exploitation of valuable resources

- One has to find a best possible balance between the state's interest and the oil companies' interest

The fiscal policy
The fiscal package

- The fiscal packages can be characterized both by the
  - The tax level
  - The tax system

- The fiscal policy can create disincentives to explore or to exploit the petroleum resources due to either the tax level or the tax system

- A key question to any fiscal package is whether it will influence the investment decision of the investor adversely with respects to the nation optimal decisions.

The fiscal policy
Government objective

- Important to create a win-win situations between the state and the oil companies

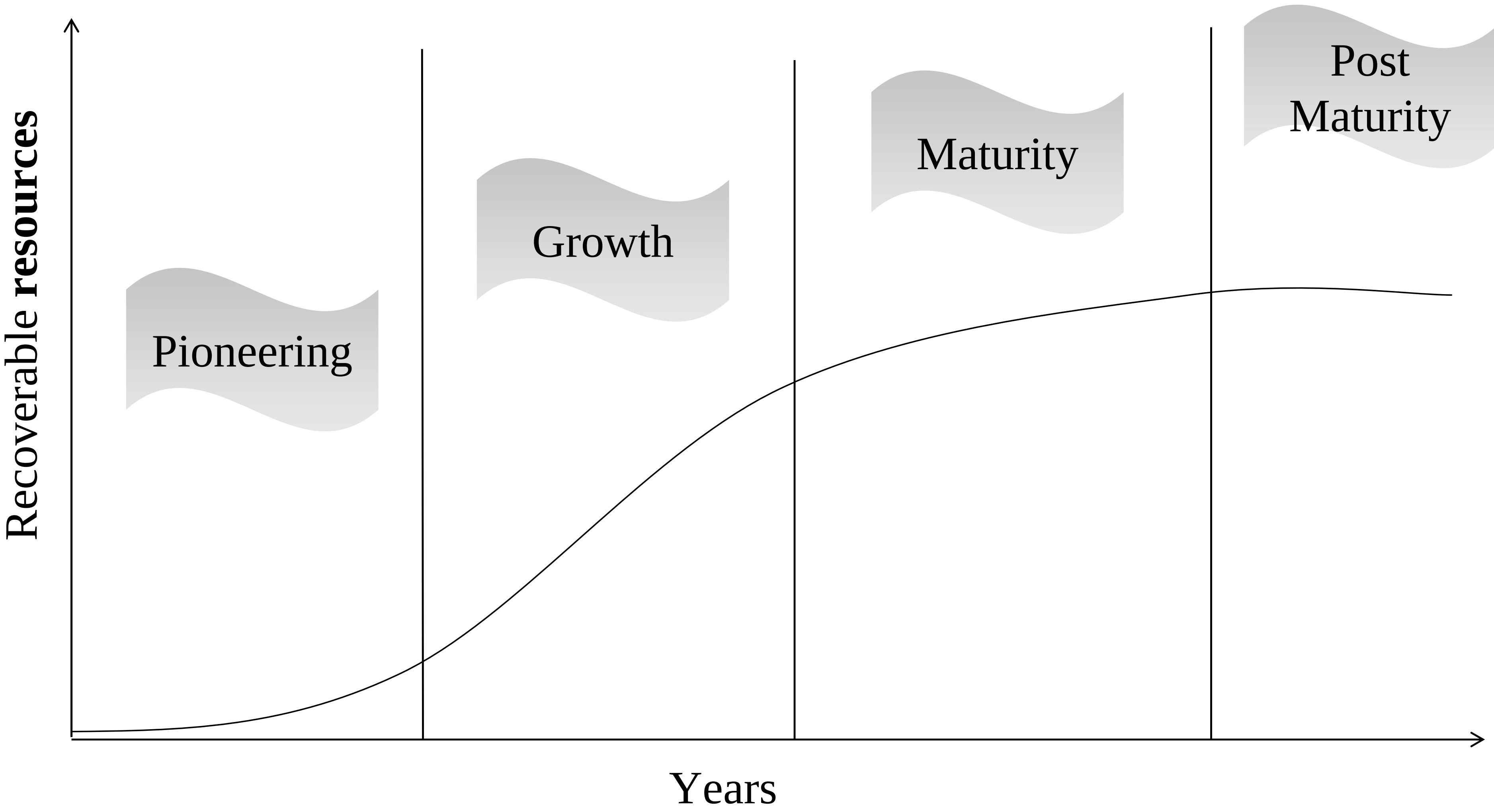
- The bargaining relationship depends mainly on the profitability and the risk
  - The Government has to take the mother earth and the geological potential into consideration when it designs the fiscal package

- Crucial to relate the fiscal package on the geological basis and where on the geological learning curve that province is.

Relate the fiscal packages on the geological basis and where on the geological learning curve the country is

NPD

The geological learning curve

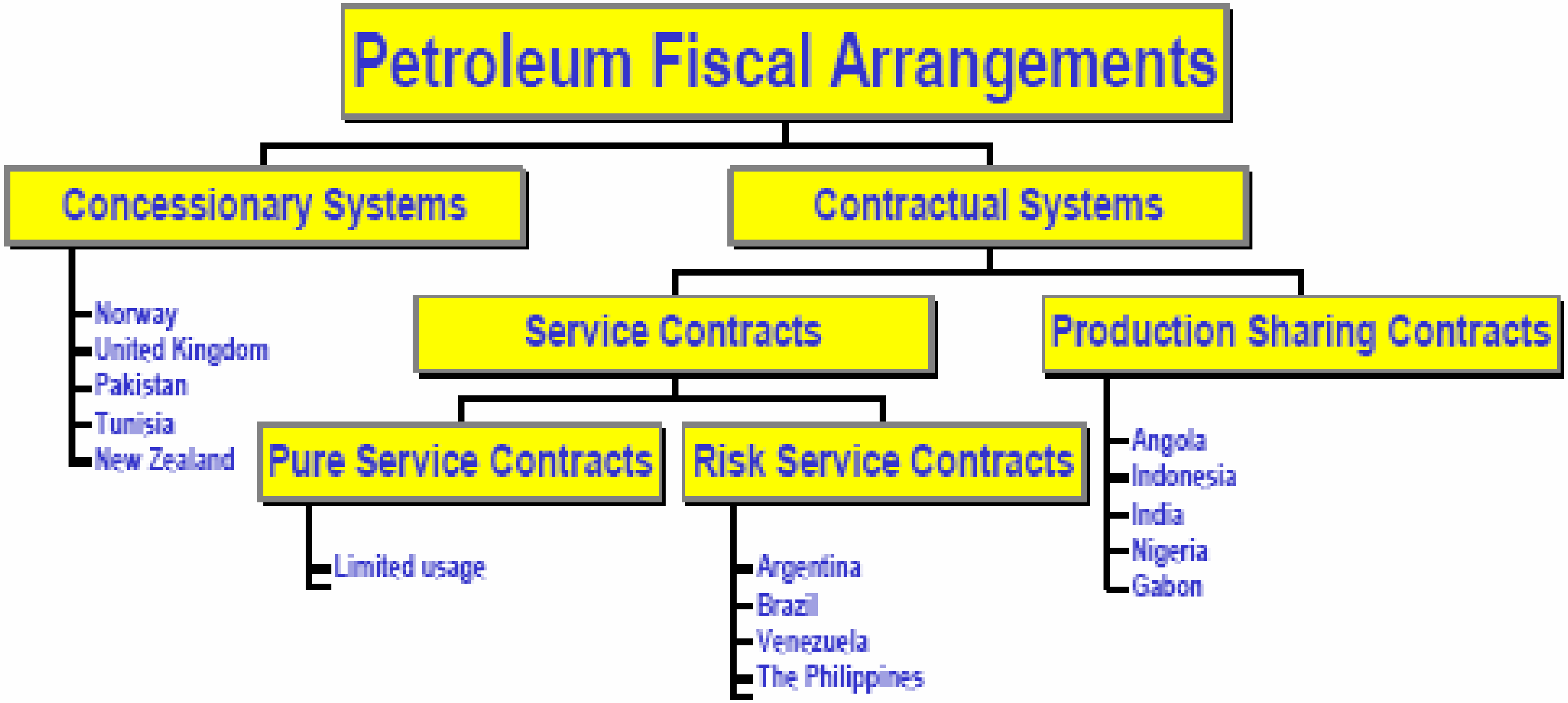


Petroleum Fiscal Systems
The two main “families”

- Concessionary system
  - Allows private ownership to mineral resources

- Contractual system
  - The State retains ownership to mineral resources

The Government Choice



Petroleum Fiscal Systems
Concessionary System

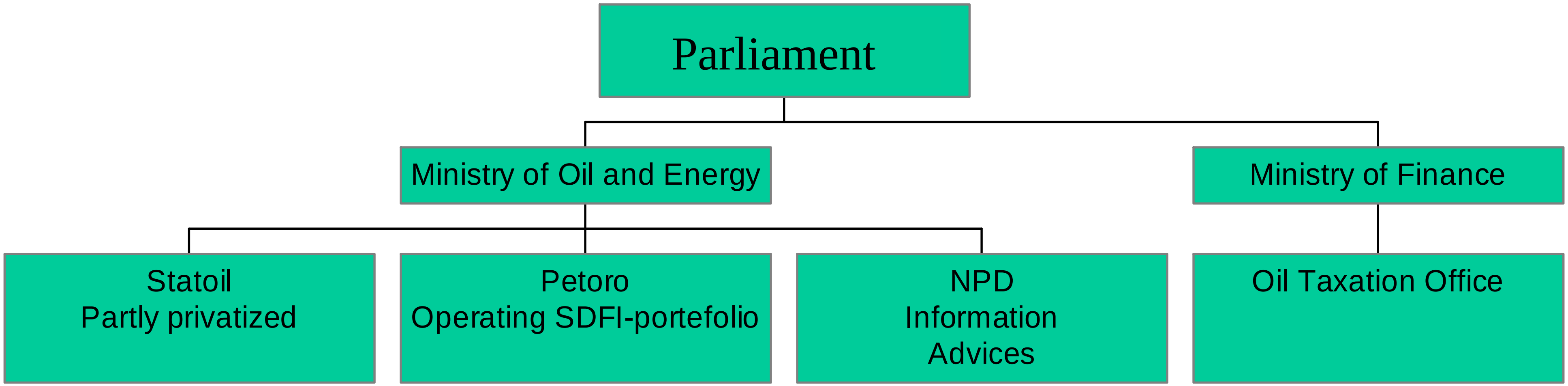
- Oil company have exclusive right to explore and produce at its own risk and expense
- Oil company owns the production
- Oil company often pays royalty and surface rental to the State
- Oil company pays tax on the profit
- Oil company owns the equipment

Taxation in Norway
The petroleum arrangements

- Exploration and production licences granted by the Ministry of Petroleum and Energy based on:
  - Technical competence
  - Work programme
  - Financial strength

- The E&P Licences organised as Unincorporated Joint Ventures
  - Licences are not tax subjects (each company is)
  - Costs are shared pro-rata between the companies
  - Each partner lift and sell own oil and gas

Taxation in Norway
Roles and responsibilities



Taxation in Norway

NPDs role

- No direct role

However:

- National Budget Reporting
- Approval of development plans
- Advising the Ministry with respect to SDFI-participation license awards
- General advices with respect to possible consequences of tax effects
- Valuation of SDFI-interests in a sales process in 2001 and 2002

  - sold to Statoil (15%) and the other companies (6%)

Taxation in Norway
The regulations

- General Tax Act (1999)
  - General tax law applicable to all companies and legal persons resident in Norway or having a permanent establishment here
- Petroleum Tax Act (1975)
  - Legal basis for taxation of all activities on the NCS
  - Special tax rules for petroleum exploration and transportation
- Petroleum Act (1996)
  - Royalty and Area Fee
- CO_2 Tax Act (1990)
  - Tax on fuel and flare gas and diesel consumed on production installations
- Abandonment Act (1985)
  - Government Grant for abandonment costs

Taxation in Norway
Neutral taxation

The aim is to design the tax system so that investors after-tax decisions do not differ from the pre-tax decisions.

- The marginal tax share of incomes:

  - The taxes capture a part of the income (royalties, corporate tax, special tax elements, participation, etc.)

- The marginal tax share of costs:

  - The taxes cover a part of the costs through tax deductions (depreciation of capital costs and operating costs, participation, etc.)

Taxation in Norway

Neutral taxation contd.

- Due to the introduction of the tax shares the parties only pay a part of the costs and only get a part of the incomes.

- If the effects of the taxation are such that the company's share of the incomes equals the company's share of the costs, then:
  - the relative relation between income and outcome in the after-tax cash-flow do not differ from the pre-tax cash flow
  - the introduction of the tax share do not change the decisions

We define the fiscal package to be neutral if after-tax decisions are identical to pre-tax decisions.

Taxation in Norway

Government take

- Special petroleum taxation due to extra-ordinary profits ("resource rent") from extraction of petroleum
  - The petroleum resources belong to the State
  - Oil companies get access to extraction "free-of-charge"
  - Revenues to the State should be maximised
- State Direct Financial Interest (SDFI) - State ownership in in many licences
  - Covers costs and receive profits according to the interest
  - Managed by a separate state owned company – PETORO
  - ~40-45 % of the State's revenue from the petroleum sector
- Dividend from the partly State owned companies Statoil (70 %) and Hydro (44 %)

Taxation in Norway

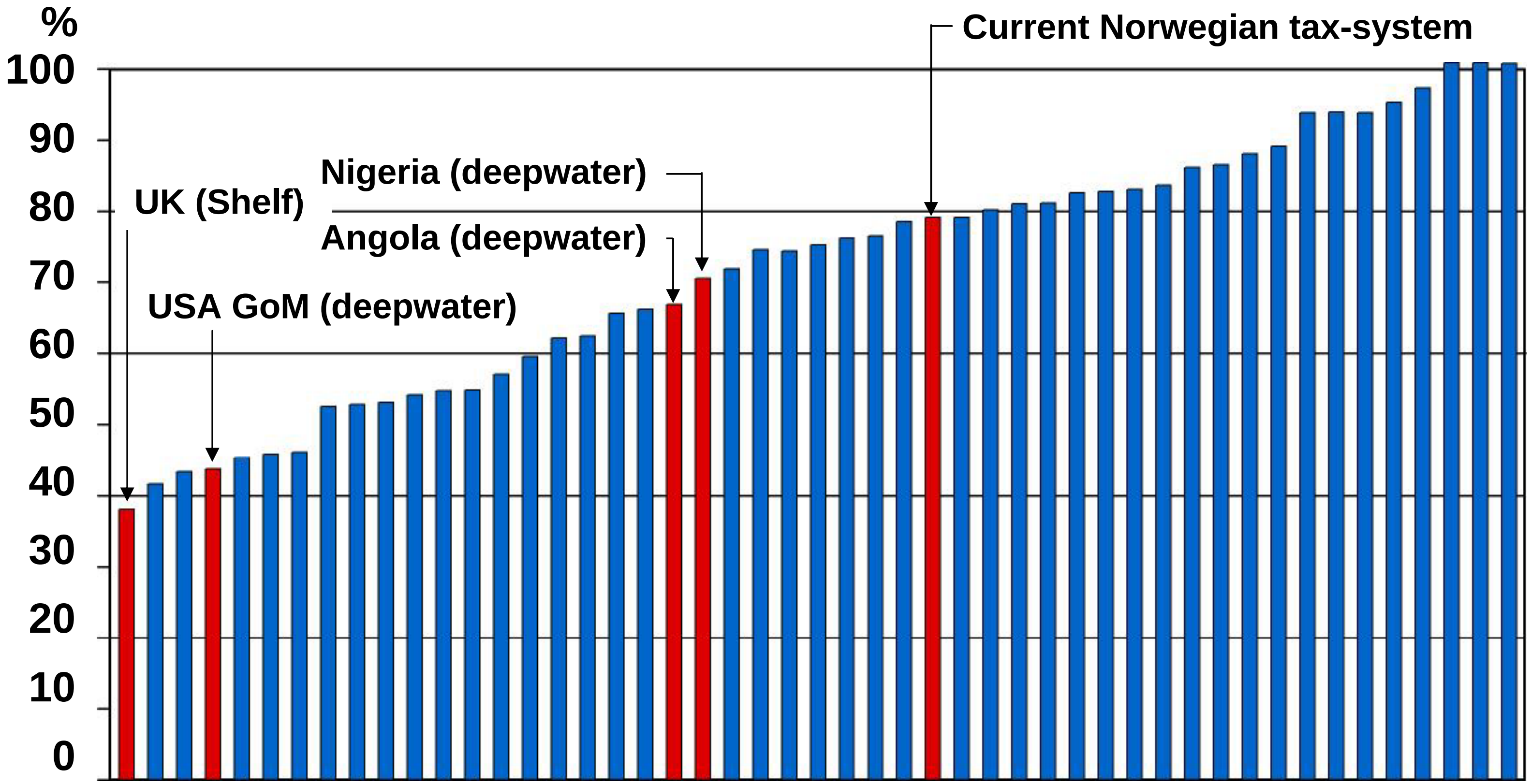
Fiscal regime for petroleum activities

- Corporate tax (28 %) on net profit
- Special petroleum tax (50 %) on net profit
- Royalty of 8-16 % on gross production value
  - From 1986 only on oil production
  - No royalty on fields developed after 1986
  - Is being phased out by year 2005
- CO_2 fee
  - 0,78 NOK per standard cubic metres of consumed gas / litre of diesel ~ USD 45 per tonne CO_2 emitted
- State Direct Financial Interest
  - The Norwegian state's direct financial interest in licences
  - Administrated by a separate state owned company - Petoro

Petroleum Taxation

Government take comparison

Average government take for oil-fields in different countries (%)



Source: Wood Mackenzie

Norwegian Taxation
Summary

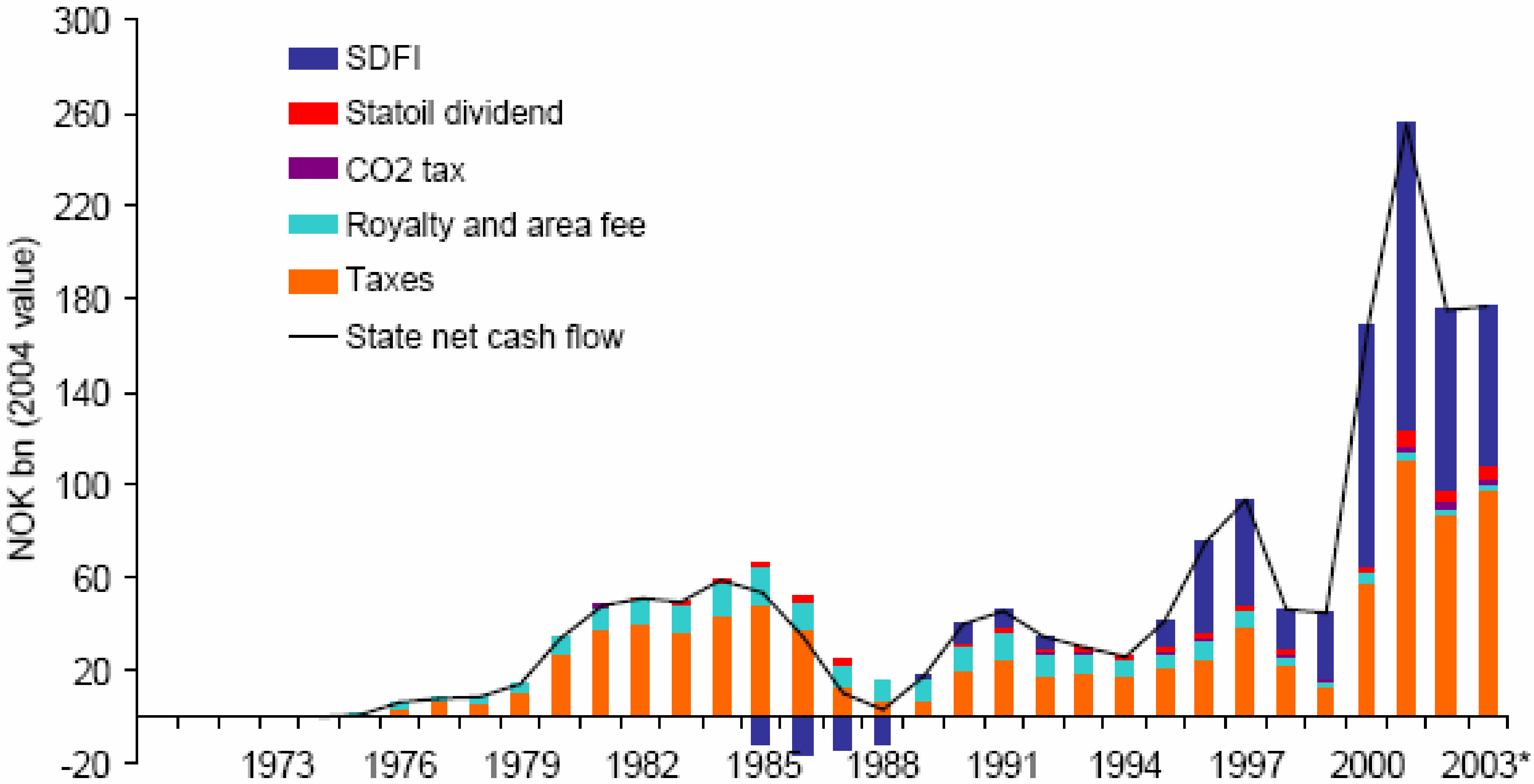
- **High tax rate**

  (78 % marginal tax rate)

  <u>but:</u>

- "Neutral" system
- Full tax consolidation
- Immediate deduction for exploration costs
- Favourable tax depreciation and uplift from year of investment
- Deduction of interest also in Special Tax calculation
- Reduced risk if unsuccessful exploration, cost overruns and reduced oil prices
- No profit sharing, signature bonuses or auctions
- No royalty (after 2005)

Net cash flow to the state from petroleum operations*

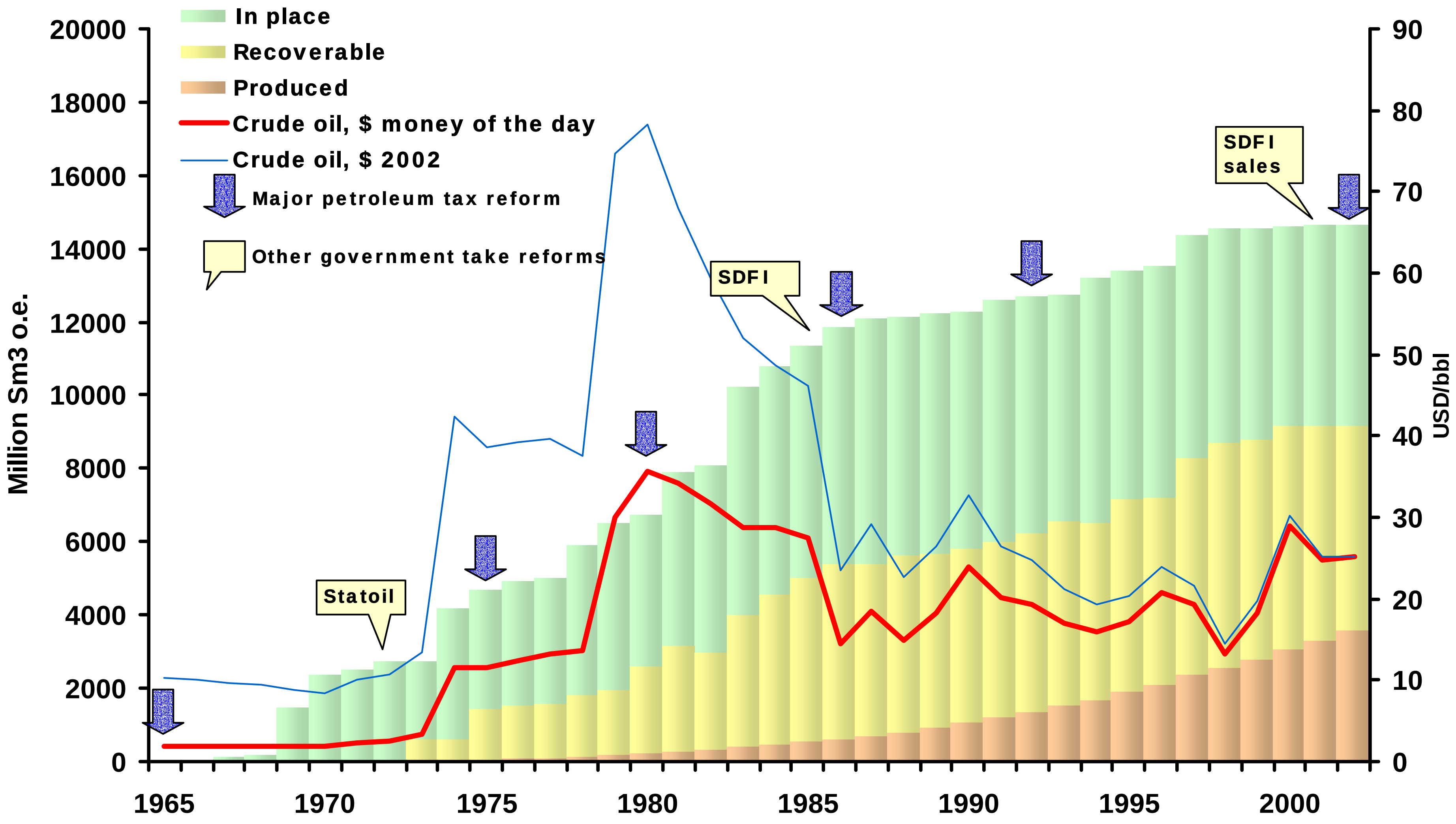


1 US$ ~ 6,5 NOK

*2003 estimate

Taxation in Norway

Adjustments over time



Taxation in Norway
Stability and predictability contd.

- Adjustments in 2002
  - New interest allocation rules
- Adjustments in 2004 - to attract new investors and improve profitability of "marginal projects":

- The uplift will be accelerated to 7.5 per cent over 4 years.
- The Government will reimburse the tax value of exploration deficits in connection with the tax assessment.
- The Government will reimburse the tax value of deficits at termination of activity.
- Simplification of the tax treatment in connection with transfer of licences.
- Changes in the tax rules for depreciation of investments with a shorter economic life than six years.
- Larger flexibility in contracts between oil companies and contractors (so-called incentive contracts).

Norwegian Taxation

Summary

Current Petroleum Tax System:

- Efficient as seen from the State's point of view
  - Development of proven fields
  - High government take
  - All major oil companies are represented

- Acceptable fiscal framework for the industry for existing fields

- Dialogue in 2004 between the industry and the State on future activity with main focus on:
  - Fiscal condition for new exploration
  - Tail-end production and IOR

  → Petroleum tax system slightly adjusted (and high oil prices gave increased activity...)

Taxation in Norway
Specifics of the net income tax calculation

- Operating costs
  - Tax deductible in year incurred
- Exploration costs
  - Tax deductible in the year incurred
- Development cost
  - Linear depreciation over 6 years
  - 7,5 % uplift for 4 years (30 %) against Special Tax based on investments
  - Depreciation and uplift starts in the year of the investment
- Financial costs
  - Deductible in the year incurred
  - Allocation between onshore and offshore
  - Thin capitalisation rules (max 80 % debt)

Taxation in Norway

Ring-fence of petroleum profits

- Petroleum activities confine oil exploration, exploitation and pipeline transport

- Corporate tax is charged on a company basis
  - No ring fence on the NCS-activity

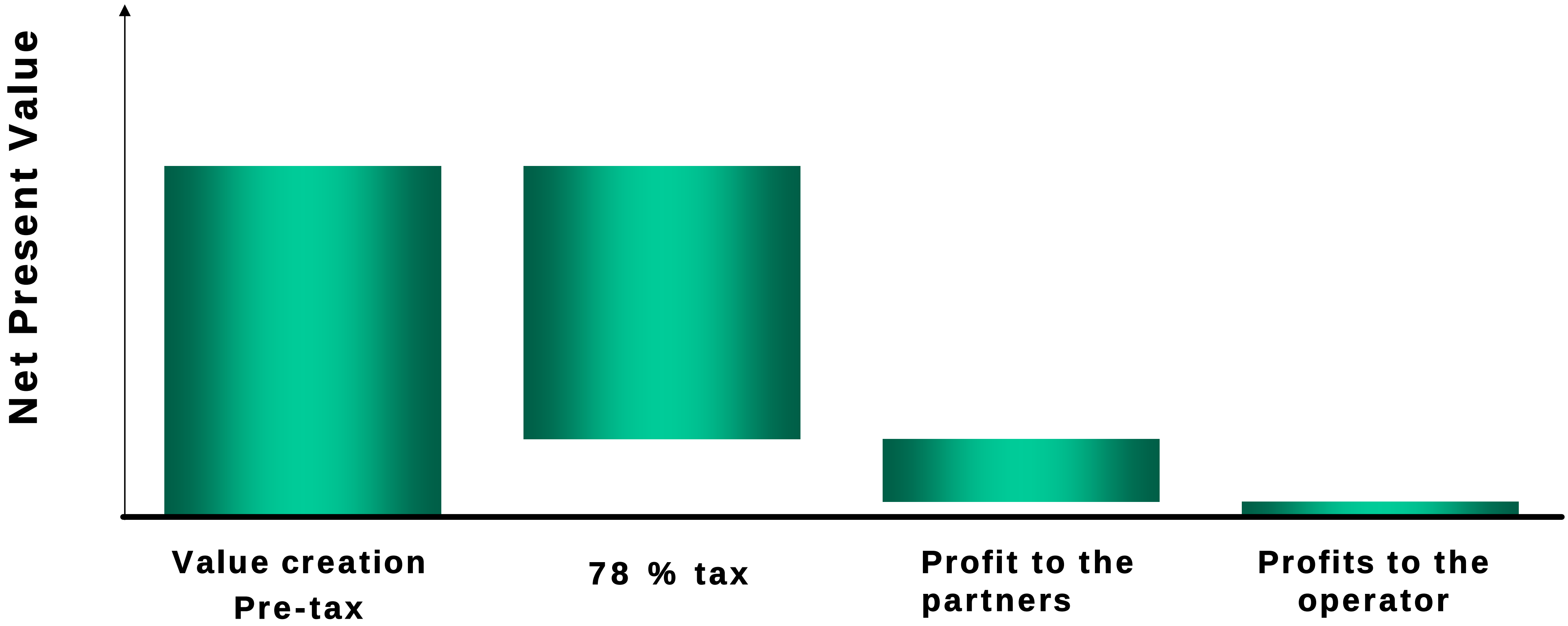
- Petroleum activity is subject to special "ring-fence rules"
  - 50 % of losses onshore can be offset against offshore income, but only against the 28% corporate tax
  - Losses from abroad can not be offset against offshore income
  - Losses within the offshore regime can effectively not be offset against onshore income

Taxation in Norway
Stability and predictability

- Main structure from 1975
  - 50,8 % Corporate Tax (effective rate after dividend deduction is 40%)
  - 25 % Special Tax
  - 150 % uplift (10 % over 15 years)
- Adjustments in 1980
  - 35 % Special Tax
  - 100 % uplift (6,67 % for 15 years)
- Tax reform in 1986
  - 30 % Special Tax
  - Uplift replaced by "Production allowance" of 15 % for new fields
- Tax reform in 1992
  - 28 % Corporate Tax
  - 50 % Special Tax
  - Uplift reintroduced, 30 % (5 % for 6 years)

Sharing the created values
General Example (Norway)

Challenge: Profitable project, but marginal for the operator



PSA – Taxation

Main principles

- Two parties; Contractor (participants) and Concessionaire (States company)
- Contractor pays 100 % of costs which are recovered through Cost Oil
- Cost Oil is a part of production normally with a ceiling each year
- Remaining part of production, Profit Oil, is shared between the Contractor and Concessionaire as a function of cumulated production ROR → Contractor's share is falling

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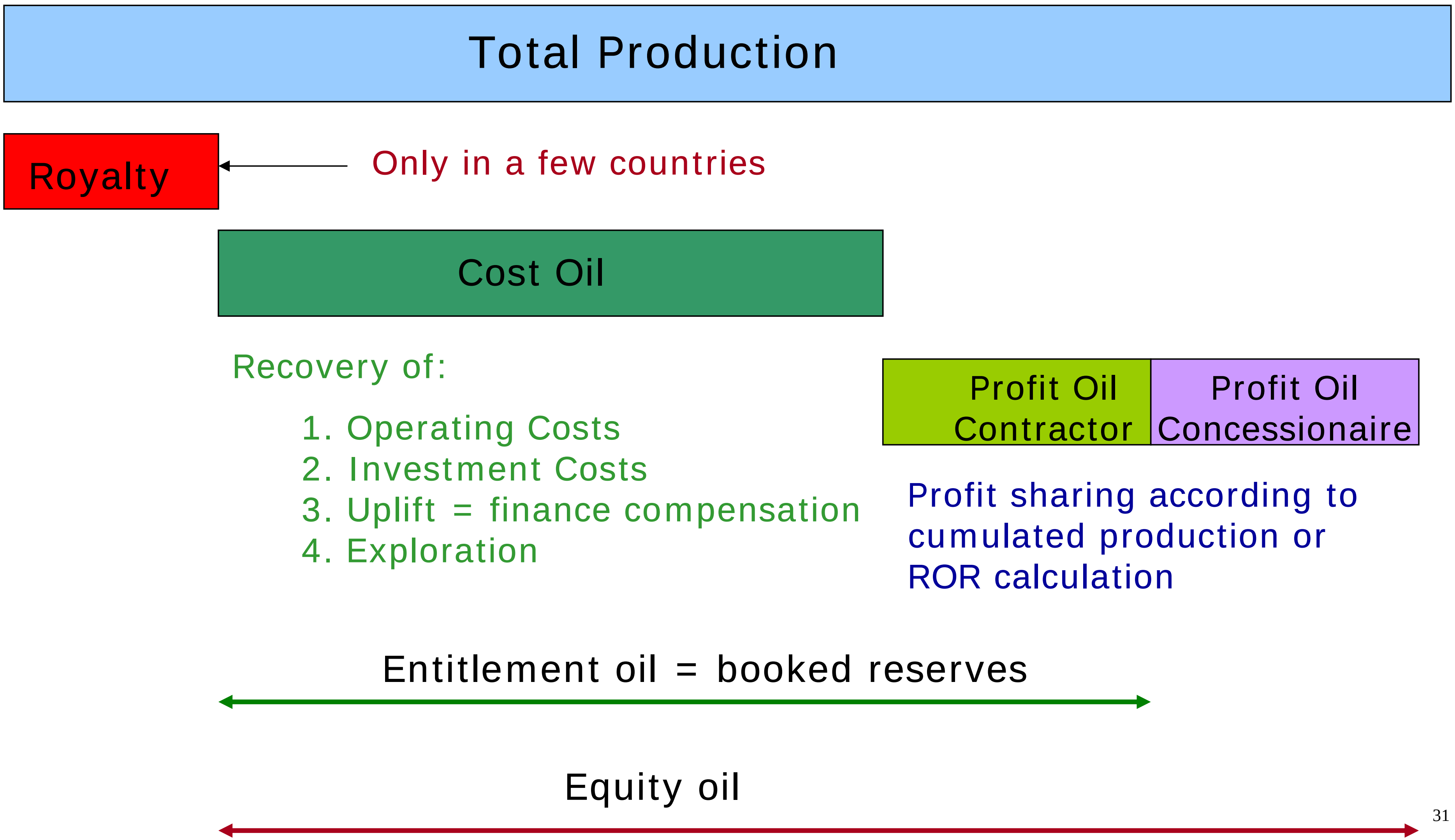
PSA – Taxation
Main principles

- Contractor is protected against future amendments in fiscal legislation through either or:
  - Law protection (the PSA has become law)
  - State guarantee
  - Economic Compensation clause in contract
- Simplified taxation; contractor is often exempted from indirect taxes like VAT and Custom Duty
- Ring fence for each PSA and for each field within the same PSA
- Signature bonuses (non recoverable and normally not deductible for tax purpose)

PSA
Typical split of production



PSA
Taxation

Total Production

Royalty | Cost Oil | Profit Oil Contractor — Gross Income

Less costs allowable for tax purposes:

Royalty

Operating costs
Depreciation of investment
Own costs (for some PSAs)
Exploration costs

Net Profit taxed at different rates

PSA – Taxation
Summary

- **Low tax rate**

  (marginal tax rate between 25% and 50%)

  but:

- Yearly cost recovery with a ceiling
- Profit sharing
- Ring fence
- Considerable non-recoverable costs