

**Presentation to
Somalia Prime Minister:
*Somalia Petroleum Law***

Malindi, Kenya

June 12, 2006

Agenda

- **Introduction of Somali Petroleum Law Team and Advisors**
- Somalia Petroleum Policy: Eleven Principles
- Proposed Petroleum Law of Somalia
- Press Release
- Suggested Timetable
- Draft Production Sharing Agreement
- Financial Features of PSA
- Somalia Petroleum Corporation
- Issues for Discussion with States
- Puntland Contract of Work
- Proposed Strategy for Discussion with Prior Concessionaires

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Partner	Macleod Dixon LLP

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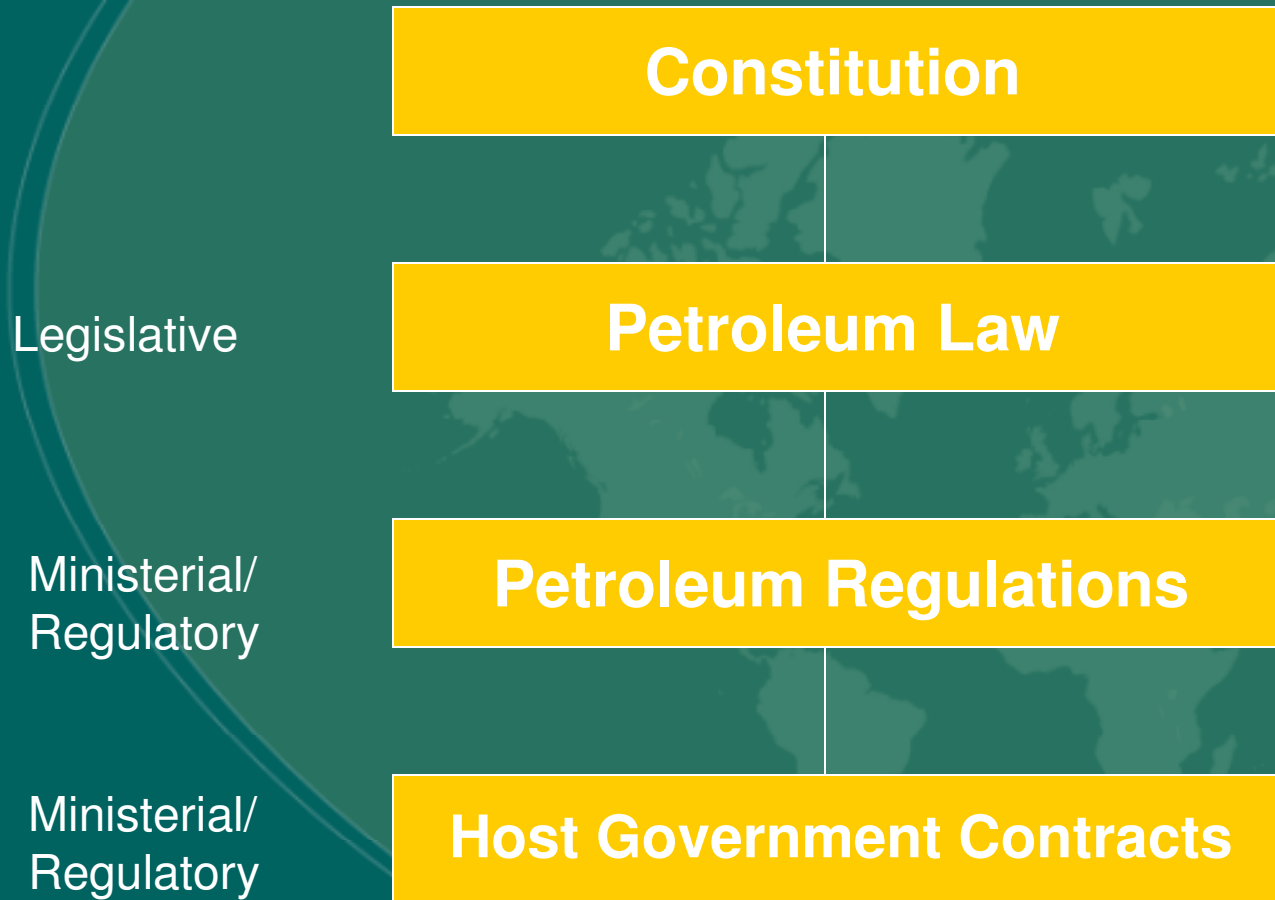
Somalia Petroleum Policy and Petroleum Law

- a *law* is designed to express a *policy* position of the legislature that enacts the law
- the policy *justifies and explains* the provisions of the law
- when the TFG delivers the proposed Petroleum Law to Somalia's parliament, parliamentarians may properly ask, "where is the policy that underlies this law? What petroleum goals and objectives are you trying to achieve?"

Somalia Petroleum Policy Principles

- the following slides describe key principles of a Somalia Petroleum Policy
- these principles are reflected in the Petroleum Law
- if we agree on these principles, then we know that the draft Petroleum Law is grounded on an agreed petroleum policy

Framework of a Petroleum Regime



Somalia Petroleum Policy: *The Charter*

- Somalia's Petroleum Policy must work within the context of its Charter and the constitution that will follow it
- The Somali Transitional Charter includes the following provisions relating to natural resources:
 - PREAMBLE: the Somali Republic is a sovereign nation, determined to foster reconciliation, national unity and good governance
 - ARTICLE 67, NATURAL RESOURCES AND THE ENVIRONMENT: 1. The natural resources of the country such as the minerals, water, flora and fauna shall be public property and *a law shall be enacted which defines the manner of exploitation for the common good*; 2. The TFG shall give priority to the protection, conservation and preservation of the environment

Somalia Petroleum Policy: *The Charter*

- ARTICLE 71 TRANSITIONAL PERIOD: 1. The Charter shall have legal effect pending the eventual enforcement of the National Federal Constitution. 2. The 1960 Somalia Constitution and other national laws shall apply in respect of all matters not covered and not inconsistent with this Charter. 9. *The present Charter shall be the basis for the federal constitution whose draft shall be completed . . .*

Somalia Petroleum Policy: *The Charter*

- SCHEDULE I POWERS OF THE TRANSITIONAL FEDERAL GOVERNMENT: 1. Foreign Affairs. 4. Establishment of State Structures. 8. Planning and Economic Development. **9. Natural Resources.** 11. Collecting import/export and indirect taxes
- SCHEDULE II POWERS OF THE STATE GOVERNMENTS: 3. Regional Roads. **4. Environmental Protection.** 7. Water and Electricity Development. 8. Agricultural Development and Water Management. 13. [11?] Settlement of population. 18. [14?] **Collect all direct taxes.** 20. [16?] Business licenses.

Somalia Petroleum Policy: *Context*

- Somalia's Petroleum Policy must recognize the context and circumstances of Somalia relating to petroleum specifically, and its economic and political situation
- Relevant context and circumstances include the following:
 - Somalia currently imports all of its petroleum requirements
 - petroleum is required for the well being of Somalis, as a fuel for transportation and power generation, and for cooking, heating and light
 - in light of Somalia's economic circumstances and petroleum prices, it is a burden on Somalia and its people to have to spend precious foreign exchange for the importation of petroleum

Somalia Petroleum Policy: *Context*

- petroleum may exist within the territory of Somalia
 - nearby states have discovered petroleum
- Somalia could benefit if petroleum is discovered here
 - reduce or eliminate imports of petroleum
 - if sufficient quantities discovered, earn revenues from export

Somalia Petroleum Policy: *Context*

- undiscovered petroleum within Somalia is much like *rumours of buried treasure*
 - it might be here, it might not; if it exists, we may or may not find it
- petroleum is a *temporal* treasure
 - it had no value before 1870
 - as replacement energy sources are developed, it will probably have little value after 2070
 - "The end of the oil age is near. The stone age did not end for lack of stone; the oil age will not end for lack of oil." *Sheikh Zaki Yamani, former Minister of Oil, Saudi Arabia*
 - the grandchildren of today's Somalis will not thank them for saving petroleum for future discovery and use

Somalia Petroleum Policy: *Context*

- Somalia has been blessed with lands and waters that have permitted its people to benefit from an agricultural and fishing economy for centuries
- if petroleum is discovered, Somalia may be able to expand its economy to include petroleum development
- if there is no petroleum in Somalia, then Somalis will need to continue to rely on Somalia's agricultural and fishing resources, and pursue other types of economic development
- *the Government of Somalia, as a principle of economic planning, should investigate the potential existence of petroleum in Somalia*
- BUT the "age of oil" is temporary, and agriculture and fishing are forever, so *if oil is discovered, it should be exploited in a way that does not harm Somalia's long term resources: its air, land, waters, flora and fauna*

Somalia Petroleum Policy: *Principles 1 and 2*

- Principle 1: *Somalia should undertake an effort to discover whether petroleum exists within its territory, so that the people of Somalia can benefit from it.*
- Principle 2: *Activities to explore for, (and if exploration results are successful) develop and produce petroleum in Somalia must not unduly adversely affect the Somali environment (air, water, land, flora and fauna).*

Somalia Petroleum Policy: *Consequences of Principle 1*

- it will require extensive reconnaissance and the drilling of at least 100 to 200 wells to determine whether Somalia has petroleum resources within its territory
- the Government of Somalia could undertake this; but:
 - drilling is a risky enterprise
 - > 9 out of every 10 exploratory wells are dry
 - drilling is an expensive enterprise
 - wells cost from \$4 million to \$30 million each, depending on various factors
 - petroleum exploration, development and production requires specialized knowledge and expertise
 - it has been said that "*oil is found in the minds of men*"
- the Somali Republic currently lacks the financial and technical resources to explore for oil by itself
- there are foreign enterprises who are qualified financially and technically to do so, and are prepared to take the exploration risks involved

Somalia Petroleum Policy: *Principle 3*

- Principle 3: *Suitably qualified foreign enterprises should be invited to explore for, develop and produce petroleum in Somalia*

Somalia Petroleum Policy: *Consequences of Principle 3*

- international oil companies ("IOCs") decide whether to invest based on three criteria, in this order:
 - 1. attractiveness of the geology
 - 2. attractiveness of the petroleum financial regime
 - 3. attractiveness of the political/legal regime
- Somalia cannot control #1, but it can control #2 and #3

Somalia Petroleum Policy: *Principle 4*

- Principle 4: *Somalia's financial, legal and regulatory regime for petroleum should make it attractive to enterprises to explore, develop and produce petroleum in Somalia, and provide investors with assurance of stability*
- Then, if Somalia's geology is sufficiently attractive, IOCs will explore

Somalia Petroleum Policy: *Consequences of Principle 4*

- Somalia is entitled to compensation ("economic rent") for the exploitation of its resources
- there are many financial tools that can be used to extract this rent
 - payments before discovery
 - signature bonuses, acreage-based rental payments, local benefits
 - payments after discovery
 - royalty, profit share, production bonuses, corporate taxes
- generally, the more you ask for in payment before discovery, the less you can expect as payment after discovery
- similarly, the timing of payments after discovery may vary depending on the timing and profitability of the discovery
- aspects of risk sharing and income deferral are involved here; how much risk is Somalia willing to take? How long is Somalia willing to wait to receive its share of revenues?
- *Somalia needs revenue now, so it should seek revenues from petroleum exploration throughout the life of petroleum activities*

Somalia Petroleum Policy: *Consequences of Principle 4*

- exploration, development and production of petroleum in other countries has a mixed history
 - some early grants in the form of concessions were tantamount to a relinquishment of sovereignty by the host state
 - often these grants did not involved a fair sharing of the results of the exploration, especially as petroleum activities became more profitable
 - this has sometimes resulted in expropriation by the state of the IOCs' petroleum rights
 - these factors tend to make states wary of IOC investment, and IOCs wary of investing in states whose political stability is uncertain
 - *Somalia should avoid repeating these problems*

Key Attributes of Host Government Contract

Type of agreement

Exclusive rights to explore and produce

Ownership of production

■ **Concession**

Private company

Private company

■ **Joint Venture**

Shared

Shared

■ **Production sharing**

State company

Shared

■ **Service Contract**

State company

State company

Usage of Host Government Contract Types

Type of agreement

Number of countries utilizing this type

■ Concession	59
■ Joint Venture	31
■ Production Sharing	40
■ Service Contract	3
■ Hybrids	16

Somalia Petroleum Policy: *Principles 5, 6, 7*

- Principle 5: *Somalia should adopt the Production Sharing Agreement as the principal form of host government contract to be used in Somalia*
- Principle 6: *The grant of petroleum rights under a Production Sharing Agreement should involve a signature bonus, and a share of profits resulting from successful petroleum exploration*
- Principle 7: *Somalia's share of profits from successful petroleum exploration should increase as the profitability of the venture increases, to ensure a fair share of profits and a durable fiscal structure*

Somalia Petroleum Policy: *Consequences of Principle 4*

- benefits of petroleum development have not always been shared equitably, especially with those who bear some of its costs
- social and environmental consequences of petroleum development have not always been properly mitigated
- regional governments in Somalia have legislative power over some activities (local taxes, authorisations, etc.) that occur in petroleum operations, so regional and local consultations are necessary for petroleum activities to occur
- *Somalia should ensure that proceeds are shared equitably among the people of Somalia*

Somalia Petroleum Policy: *Principle 8*

- Principle 8: *The state's share of the benefits of petroleum exploration should be equitably shared among all Somalis, federally, regionally and locally*

Somalia Petroleum Policy: *Consequences of Principle 4*

- petroleum development in resource-based economies has led to other unfortunate consequences, sometimes referred to as the "resource curse"
 - corruption
 - conflict
 - lack of development of democratic government
- Somalia is *not* a resource based economy
 - Somalis should "pray to be so cursed" with valuable natural resources
- but *it would be prudent to establish a petroleum regime that minimizes the risks of the resource curse*, in case petroleum is discovered
 - such as the principles of the Extractive Industries Transparency Initiative

Somalia Petroleum Policy: *Principle 9*

- Principle 9: *Somalia should adopt principles of transparency in the conduct of petroleum operations to minimize the risks of the "resource curse"*

Somalia Petroleum Policy: *Additional Goals*

- Sometimes petroleum activities leave little behind as benefits to local citizens
- *successful petroleum activities in Somalia should raise the Somali economy generally, and enhance the skills and capabilities of Somalia and its citizens*

Somalia Petroleum Policy: *Principles 10 and 11*

- Principle 10: *Somalia should establish a national oil company controlled by the state to participate in successful petroleum activities in Somalia*
- Principle 11: *Petroleum operations in Somalia should involve the use of local goods and services and the employment of qualified Somali citizens to the greatest extent possible, and should ensure that Somali citizens receive training to enhance their skills*

Somalia Petroleum Policy: Eleven Principles

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- Principle 3: *Suitably qualified foreign enterprises should be invited to explore for, develop and produce petroleum in Somalia.*
- Principle 4: *Somalia's financial, legal and regulatory regime should make it attractive to enterprises to explore, develop and produce petroleum in Somalia, and provide investors with assurance of stability.*
- Principle 5: *Somalia should adopt the Production Sharing Agreement as the principal form of host government contract to be used in Somalia.*
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- Principle 9: *Somalia should adopt principles of transparency in the conduct of petroleum operations to minimize the risks of the "resource curse".*
- Principle 10: *Somalia should establish a national oil company controlled by the state to participate in successful petroleum activities in Somalia.*
- Principle 11: *Petroleum operations in Somalia should involve the use of local goods and services and the employment of qualified Somali citizens to the greatest extent possible, and should ensure that Somali citizens receive training to enhance their skills.*

Somalia Petroleum Policy: Subsidiary Principles

- "separation of roles" regulatory structure: Ministry of Natural Resources to define policy; regulatory agency to award authorisations and regulate activities; national oil company to perform commercial activities
- "good oil field practice" is the required standard of care
- rights of existing concessionaires entitle them to an opportunity to replace the concession with a PSA
- regulatory principles of equality, transparency, openness, accountability and non-discrimination
- "single window" regulation to the extent possible

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Draft Petroleum Law of Somalia

- the draft Petroleum Law for Somalia applies the eleven petroleum policy principles
- it applies international best practice in petroleum law
- it has been reviewed in detail by the Somalia Petroleum Law Team and its advisors
- the Somalia Petroleum Law Team is ready to present the Petroleum Law *today* to the Prime Minister and the Minister of Petroleum for delivery to the Council of Ministers for review, with a recommendation of its endorsement

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Press Release

- The Somalia Petroleum Law Team has prepared a press release for your approval relating to the delivery to you today of the Petroleum Law
- we hope this meets with your approval

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Suggested Timetable re Petroleum Law

- *June 12*
 - Delivery of Petroleum Law to Prime Minister
- *June 15- 20*
 - Translation of Petroleum Law to Somali
- *June 21- 25*
 - Council of Ministers review of Petroleum Law
 - Printing of Petroleum Law Bill
- *June 26- July 10*
 - Transitional Federal Parliament review of Petroleum Law Bill
- *July 15- July 25*
 - TFG President assent
 - Petroleum Law comes into force on July 25

Suggested Timetable re Petroleum Activities

- *June 12- August 15*
 - completion of model Production Sharing Agreement, Surface Authorisation, Reconnaissance Authorisation
 - preparation of shareholder agreement and bylaws of Somalia Petroleum Corporation
 - preparation of relevant Regulations under Petroleum Law
- *August 31*
 - MedcoEnergi and Kuwait Energy to acquire 49% of Somalia Petroleum Corporation
 - Minister of Petroleum to approve three directors to Somalia Petroleum Corporation (2 from Medco, 1 from KE) out of a total of seven
- *September 15*
 - Minister of Petroleum to send letter to selected prior concessionaires
 - followup on negotiation with prior concessionaires by Ministry of Petroleum team

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Draft Production Sharing Agreement

- a draft model Production Sharing Agreement has been prepared to permit the review of the proposed terms of the "host government contract" for Somalia
- this document applies and elaborates on the principles of the Somalia Petroleum Policy, and the draft Petroleum Law
- further review and drafting is required
- it will be completed and ready for approval as a model by the time the Petroleum Law has been passed

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Financial Features of PSA

- The draft Production Sharing Agreement proposes a number of different payments by the Contractor to the Government
 - BEFORE PRODUCTION
 - signature bonus (bid dependent or negotiated)
 - acreage-based rental payments (US\$10/km²)
 - local government and community benefits (US\$500,000 per annum)
 - training fee (US\$100,000 per year)

Financial Features of PSA

- AFTER PRODUCTION
 - royalty (sliding scale)
 - profit share of production (sliding scale)
 - local government and community benefits (sliding scale)
 - production bonuses
 - acreage-based rental payments (US\$100/km²)
 - participation right
 - Somali Petroleum Corporation and Regional Owned Contractor may elect to participate in 40% (30% SPC, 10% Regional-Owned Contractor) participation interest to develop petroleum reserve if any discovery
 - no payment for "sunk costs"

Revenue Distribution in Contract Life

Revenue Distribution @ Oil Reserve

	50 million bbl		150 million bbl		250 million bbl		350 million bbl	
	Mill.US\$	%	Mill.US\$	%	Mill.US\$	%	Mill.US\$	%
Gross Revenue	2,234	100.0%	6,701	100.0%	11,168	100.0%	15,636	100.0%
Government Share	1,047	46.9%	3,201	47.8%	5,495	49.2%	7,955	50.9%
Royalty	134	6.0%	441	6.6%	821	7.3%	1,247	8.0%
Profit Split to Gov.	751	33.6%	2,306	34.4%	3,958	35.4%	5,733	36.7%
Signature Bonus	4.0	0.2%	4.0	0.1%	4.0	0.0%	4.0	0.0%
Rental & Land Fee	1.6	0.1%	1.6	0.02%	1.6	0.01%	1.6	0.0%
Training & Program Fee	2.0	0.1%	2.0	0.03%	2.0	0.02%	2.0	0.0%
Production Bonus	3.0	0.1%	13.0	0.2%	21.0	0.2%	53.4	0.3%
Local Comm. Benefit	151	6.8%	434	6.5%	688	6.2%	914	5.8%
Contractor Share	1,187	53.1%	3,500	52.2%	5,673	50.8%	7,681	49.1%
Profit Oil	740	33.1%	2,160	32.2%	3,439	30.8%	4,554	29.1%
Contractor	553	24.8%	1,614	24.1%	2,569	23.0%	3,402	21.8%
SPC	113	5.1%	330	4.9%	526	4.7%	697	4.5%
State Owned Cont.	74	3.3%	216	3.2%	344	3.1%	455	2.9%
Contractor Cost :								
Capital Expenditure	223	10.0%	670	10.0%	1,117	10.0%	1,564	10.0%
Operating Expens	223	10.0%	670	10.0%	1,117	10.0%	1,564	10.0%
Total Government Share	1,234	55.2%	3,747	55.9%	6,365	57.0%	9,107	58.2%

note : - Oil Price 50 usd/b

Summary : Profit Oil Distribution in Contract Life

(revenue minus total Cost)

Revenue Distribution excluded Total Cost @ Oil Reserve

	50 million bbl		150 million bbl		250 million bbl		350 million bbl	
	Mill.US\$	%	Mill.US\$	%	Mill.US\$	%	Mill.US\$	%
Government Share	1,047	58.6%	3,201	59.7%	5,495	61.5%	7,955	63.6%
SPC	113	6.3%	330	6.2%	526	5.9%	697	5.6%
State Owned Cont.	74	4.1%	216	4.0%	344	3.8%	455	3.6%
	1,234	69.1%	3,747	69.9%	6,365	71.2%	9,107	72.8%
Contractor	553	30.9%	1,614	30.1%	2,569	28.8%	3,402	27.2%

note : - Oil Price 50 usd/b

Economic Comparison of Some Fiscal Regime

Economic Result - OIL

% of Gross Revenue

	Indonesia	Libya	Algeria	Syria	Oman	Yemen	Somali *)
Contractor							
Profit / Capex	1.1	1.0	1.2	1.8	1.6	2.3	2.5
Profit / (Capex + Opex)	0.5	0.7	0.6	0.9	0.8	1.1	1.2
Total Cost	20%	8%	20%	20%	20%	20%	20%
Total Contractor Share	31%	14%	32%	38%	36%	43%	45%
Government							
Total Gov. Cost	0%	12%	0%	0%	0%	0%	0%
Total Gov. Share	69%	86%	68%	62%	64%	57%	55%
Net Government Share	69%	74%	68%	62%	64%	57%	55%
% of Gross Revenue minus total cost							
Contractor Share	14%	9%	15%	23%	20%	29%	31%
Government Share	86%	91%	85%	77%	80%	72%	69%

Note:

Capex = exploration capex + development capex

Total Cost = total capex + total opex

Total Contractor Share = contractor net profit + cost recovery

Production Rate = less than 25,000 bopd

Somali *) = propose

Financial Features of PSA

- Draft PSA uses all of these financial tools, but exempts Contractor from income tax
- the Charter provides that States have power over certain aspects of petroleum operations, including direct taxation
- therefore it will be necessary to share the "financial pie" with State governments and local communities
- this will require negotiations on the part of the TFG

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Somalia Petroleum Corporation

- many countries with oil & gas resources have established a state-owned company to be involved in those activities
- the Petroleum Law will create "Somalia Petroleum Corporation" as a Government-controlled company for the conduct of petroleum operations in Somalia
- Somalia Petroleum Corporation will have the power to exercise the Government's right to participate in activities under the Production Sharing Agreement for up to 30%, once commercial discovery has occurred
- the Petroleum Law gives a similar right to the government of each Regional State in Somalia where petroleum activities may occur, with a participation right of up to 10%

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Issues for Discussion with States

- the Charter gives State governments some controls over petroleum operations
- cooperation of State governments is required in order to permit petroleum operations to occur
 - "cooperative federalism" is required
- the following matters need to be addressed:
 - sharing of petroleum revenues under the PSA
 - relief from taxation
 - local approvals: environment, roads, water, electricity

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- Draft Production Sharing Agreement
- Financial Features of PSA
- Somalia Petroleum Corporation
- Issues for Discussion with States
- **Puntland Contract of Work**
- Proposed Strategy for Discussion with Prior Concessionaires

Puntland Contract of Work

- The Contract of Work between Puntland Government and Consort Private Limited contains many flaws, including:
 - inexperienced contractor
 - no work commitment
 - no agreed royalty
 - very modest bonus
 - excessive period to conduct work
 - excessive block size
 - no relinquishment obligation
 - no effective government controls on activities
 - no recognition of prior rights
 - all mineral and petroleum rights included

Consequences of Puntland Contract of Work

- potential claim by holders of prior rights
 - action likely against TFG
 - ironically, prior rights were much more generous to government than the Contract of Work
- sterilization of petroleum activity in Puntland for many years except pursuant to Contract of Work
- possible objections by local citizens

Agenda

- Introduction of Somali Petroleum Law Team and Advisors
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Proposed Strategy for Discussion with Prior Concessionaires

- it is proposed that holders of petroleum concessions granted before 1991 be offered the opportunity to replace their concessions with Production Sharing Agreements
 - new exploration period
 - new financial terms
 - new exploration obligation
- the Ministry will contact them and propose the new PSA
- any concessions not converted after one year will terminate
- this is established in the Petroleum Law

Conclusion

- The Petroleum Law of Somalia is ready for review by the Council of Ministers
- It has been prepared to reflect eleven key principles of petroleum policy that are suitable for Somalia, and to reflect international best practice
- The Somalia Petroleum Law Team recommends it for approval by the Government of Somalia

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