
THE WORLD BANK



Review of the legal, regulatory and fiscal
framework of Somalia for the Petroleum Sector

Federal Republic of Somalia



FINAL REPORT

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LIST OF ACRONYMS

"**2008 Petroleum Law**": the Petroleum Law of Somalia no. XGB/712/08 dated 6 August 2008.

"**Allocation Agreement**": the agreement to be entered between the FGS and the Member States pursuant to article 44 of the Provisional Constitution for the allocation of the natural resources of the Federal Republic of Somalia.

"**AP**": the accounting procedure in the Model PSA.

"**Authorization**": the authorization under which petroleum operations can be carried out as defined under the 2008 Petroleum Law.

"**Contractor**": a person which entered into a Production Sharing Agreement.

"**Federal Government**" or "**FGS**": the Federal Government of Somalia.

"**FRS**": the Federal Republic of Somalia.

"**IOC**": International Oil Company.

"**NOC**": National Oil Company.

"**Member States**": the Member States of the FRS.

"**Minister of Petroleum**": the Minister of the Federal Republic of Somalia in charge of the petroleum sector.

"**Model PSA**": the production sharing agreement entitled "Model Somalia PSA" dated 2007 to be signed between the Federal Government, represented by the Minister of Petroleum, and the Contractor, which is considered as having been approved by the Federal Government¹.

"**Petroleum Operations**": prospection, exploration, development, production, sale or export of Petroleum, and construction, installation or operation, or decommissioning, of any structure, facilities or installations for the performance of the above activities, as defined under the 2008 Petroleum Law.

"**Petroleum Company**": a company holding directly or predominantly rights and obligations from a petroleum contract in Somalia.

"**Provisional Constitution**": the provisional constitution adopted on 1st August 2012 by the Transitional Federal Parliament of Somali in accordance with its mission set in the Transitional Federal Charter.

"**PSA**": Production sharing agreement.

"**SPA**": the Somalia Petroleum Authority created under the 2008 Petroleum Law.

"**SOC**": the State Oil Company.

"**SPC**": the Somalia Petroleum Corporation.

"**Transitional Federal Charter**": the charter adopted at the Somali National Conference in Kenya on February 2004 for the Somali Republic and the people of Somalia.

Other terms starting with a capital letter in this report have the meaning given to them within the 2008 Petroleum Law or the Model PSA.

¹ See developments on this issue in Introduction §2.

INTRODUCTION

1. Background

The World Bank has contracted with Gide Loyrette Nouel ("**Gide**" or the "**Consultant**") for the provision of consultancy services with respect to the review of the legal, regulatory and fiscal framework of Somalia for the petroleum sector (the "**Assignment**"). Gide is assisted by Fiduciaire France Afrique (FFA Conseil) ("**EY Counsel**"), member of the Ernst and Young Group, for the fiscal, accounting and financial aspects of the Assignment.

Somalia is one of the most promising East African countries with respect to oil and gas discoveries, as underlined by the Heritage Institute for Policy Studies in 2014². Somalia also faces challenges in developing of the petroleum sector as regards to its political and security situations. Indeed, some of the regions have declared their independence (Somaliland) and have awarded exploration licenses (Somaliland and Puntland). Any oil or gas discovery in this respect is likely to catalyze an already tense political situation and enhance chance for renewed conflict.

Building a legitimate and recognized constitutional and legal framework for petroleum activities is essential in this context.

The authorities of the FRS have been established under the provisional constitution adopted on 1st August 2012 (the "**Provisional Constitution**") yet to be ratified by referendum.

The Provisional Constitution leaves a number of issues unresolved in particular, issues in relation to the federalism context of Somalia, such as definition of the powers of the various organs, including the upper house and delimitation of power of the Member States and the FGS on specific issues such as natural resources. Various processes are currently pursued for implementation of the Provisional Constitution in particular, the revision of the Constitution and the delimitation of the boundaries of the various Member States and their formation.

With respect to hydrocarbons policy and framework, in parallel of the Assignment, the authorities of the Member States and the FGS have undertaken a consultative process in order to reach agreement as regards petroleum ownership, control and revenue sharing (the "**Consultative Process**").

The main objective of the Assignment is to review the petroleum legal, regulatory and fiscal framework for the Federal Republic of Somalia to build a foundation for a federal approach to the development of natural resources. The petroleum legal framework should be in line with the Provisional Constitution (including potential amendments) and with international practices and would have to recognize both the principles of federation and decentralization. The Assignment is conducted in parallel with the Constitution revision process and the Consultative Process, and the Consultant and the World Bank liaise in this respect to communicate respective result of the ongoing processes.

As part of the Assignment, the Consultant and EY Counsel have prepared an inception report³. A kick-off workshop with the Federal Authorities was further held in Nairobi (Kenya) on the 10th and 11th November, 2015⁴.

As part of the Consultative Process, the WB held two knowledge-building workshops on petroleum resources management, at the intention of both Member States and Federal

² *Oil in Somalia, Adding Fuel to the Fire?*, Dominik Balthasar for The Heritage Institute for Policy Studies, 2014.

³ Inception Report dated 2th July 2015.

⁴ Agenda and list of participants attached as **Schedule 2**.

Authorities representatives. These workshops were held in Nairobi (Kenya), from 1st to 3rd and 15th to 17th December 2015.

The objective of this report is to provide guidance for authorities to be considered while undertaking the drafting or wider revision of the legal and fiscal framework with respect to upstream activities.

A Provisional Report has been submitted and presented to the FGS and to representatives of the Member States during a workshop in Nairobi from 2nd to 3rd June 2016. Comments on the Provisional Report were collected during the workshop and in writing on 22nd June 2016. This report is a final version of the guidance for authorities taking into account the various comments submitted to the Consultant and EY Counsel.

2. Somali petroleum legal framework

The current petroleum law at the federal level (the "**2008 Petroleum Law** ") has been adopted on August 6th, 2008 by the Transitional Federal Parliament of Somali⁵. The law is rather short (59 articles) adopting the production sharing agreement ("**PSA**") as the main form of petroleum contract and title to carry out petroleum operations in Somalia. The model production sharing agreement ("**Model PSA**") is considered to have been adopted by the Federal Government on or about the date the 2008 Petroleum Law was passed⁶. The Model PSA is currently under review with the support of the African Legal Support Facility. A revised version of the Model PSA has been provided in this context to the Consultant during the workshop on the Provisional Report (the "**Proposed Revised Model PSA**"). The Proposed Revised Model PSA takes into account most of the recommendation set in the report. The Consultant includes in **Schedule 4** below comments on the Proposed Revised Model PSA.

The 2008 Petroleum Law has been drafted in the framework of the "Transitional Federal Charter of the Somali Republic" (the "**Transitional Federal Charter**") adopted at the Somali National Conference in Kenya on February 2004.

The 2008 Petroleum Law needs to be reviewed and updated taking into account the constitutional set of rules in Somalia, meaning the Provisional Constitution, which is currently in the process for revision as mentioned above.

Somaliland and Puntland have concluded a few petroleum agreements (or amendments to pre-existing petroleum agreements) with IOCs. These Member States have not adopted new petroleum legislation but tends to use pre-existing legislation⁷.

3. Methodology

The Consultant and EY Counsel have reviewed the existing legal, regulatory and fiscal framework in order to identify (i) the key policy decisions to be made by the Somali authorities and (ii) the key areas of update to be addressed by the authorities.

⁵ Law n° XGB/712/08 dated 6 August 2008.

⁶ We understand that the Model PSA is considered as an approved model PSA although we have no information confirming official adoption of this document by any Somali public authority.

⁷ For example, hydrocarbons activities in Somaliland are regulated by the Mining Code and regulations in effect in the former Somali Republic prior to 1991.

To achieve this analysis, the Consultant studied the existing legal, regulatory and fiscal framework applicable to hydrocarbons activities in Somalia, as detailed in the above section 2, and compared it to the framework applicable to hydrocarbons activities in similar countries and to the current trends of hydrocarbons legislation.

The Consultant and EY Counsel hereby provide guidance to the Somali authorities to set the future applicable framework in Somalia. This guidance is structured as advice for enhancement of the existing framework, meaning mainly the 2008 Petroleum Law and the Model PSA. Depending on the results of the Consultative Process, such guidance may be used together with existing provisions to set proper legal, regulatory and fiscal regimes for petroleum operations at any level as may be decided.

4. **Provisional Report**

This report (the "**Provisional Report**") provides guidance to the Somali authorities with respect to issues and concerns as follows:

Part 1	• Institutional Issues
Part 2	• Public Authority's Main Concerns
Part 3	• Investor's Main Concerns
Part 4	• Fiscal and Accounting Issues

EXECUTIVE SUMMARY

Part 1 - Institutional Issues

General remarks

- **Petroleum Framework and Constitution:** The petroleum framework includes provisions in the Constitution. Prior to finalization of the reviewed petroleum law, decisions need to be taken with Member States' Governments within the Consultative Process and other current processes, namely with regard to the powers of the various organs with respect to petroleum administration, ownership and with respect to petroleum revenue allocation.
- **Type of petroleum framework:** The Somali petroleum framework shall be of a hybrid type, meaning that the petroleum law shall set the main principles and leave discretion power to the administration, which power shall be exercised within the limits set in the law. A hybrid framework allows for a strong position of the public authority in negotiations as well as for flexibility in specific circumstances. This implies a more detailed petroleum law than the 2008 Petroleum Law namely with regard to the regime of the Authorizations and the rules relating to the conduct of petroleum operations. A model PSA shall also be developed and officially adopted at the regulatory level.

Ownership, management and revenue sharing of the natural resources

- Natural resources are the ownership of the people of Somalia.
- The Consultative Process shall reach an agreement between the Federal Government of Somalia and the Governments of the Member States on the level at which the petroleum regime shall be set, and on the bodies, roles and functions for the management of the natural resources in Somalia.

Institutional structure of the Petroleum Sector

- A petroleum regime needs to define clearly which authority or agency is in charge of (i) setting and implementing petroleum policy; (ii) granting petroleum rights and overseeing petroleum contracts, including acting as repository and interpreter of technical reports and data; and (iii) verifying compliance with the applicable regulations, including in the technical, financial, health, safety, and environmental spheres.
- Two main approaches shall be considered in the Consultative Process: the centralized approach giving power to the Federal State mainly and the decentralized approach giving power to the Member States.

Petroleum rights: Somalia Authorizations

- **Reconnaissance Authorization:** This usual non-exclusive type of authorization shall be kept in the petroleum law which shall set its maximum duration (for example one year renewable). Provisions shall be added to determine rules for granting of Reconnaissance Authorization or Surface Access Authorization on PSA's areas or visa-versa.

- **PSA:** The PSA is a suitable choice of petroleum contract for Somalia. The regime of the PSA shall be further developed. The petroleum law shall set the main principles and a model PSA shall be developed and officially adopted at the regulatory level.
- **Surface Access Authorization:** Surface Access Authorization shall be an authorization to construct, install and operate structures and installations for the development, production and export of Petroleum. It shall either be granted to the holder of a PSA or to a third person. Depending on the circumstances, it will be considered upstream activities or midstream activities. The regime of this authorization shall be further developed.
- **Scope of the Petroleum Law:** The point of gross consumption is usually used to separate upstream activities, which are the subject of the petroleum law, from mid- or downstream operations.

Part 2 - Public Authority's Main Concerns

Control of the investor capacities to hold petroleum rights

- **Technical and financial capacities:** The petroleum law shall require from investors justification that they possess the necessary technical and financial capacities to conduct the petroleum operations before granting any Authorization. The regulation shall specify the documents required within the investor's application, including the type of local representation expected from the investor for the conduct of the operations.
- **Granting process transparency:** Transparency in the granting process shall be further secured. The independent authority granting Authorization shall be under the obligation to apply general principles of transparency and competitiveness, and to comply with the detailed process set in the regulation for granting Authorization.
- **Transfer and change of control:** Any transfer of Authorization to a third party as well as any change of control of the holder of an Authorization shall be subject to the public authority's prior express approval. The public authority shall then verify that the transferee has sufficient technical and financial capacity and may request adequate guarantee or commitment. The regulation may also set specific rules allowing for preemptive right of the public authority or for taxation of gains on the transaction. The law shall specify that transfer or change of control without such prior approval shall be void and that the competent authority may withdraw the concerned Authorization.
- **General information requirement:** The law shall impose transmission by the holder of information to the public authority. Certain requirement of prior approval existing in the 2008 Petroleum Law shall become mere information requirement, for instance with respect to any change in the JOA.

Control on exploration and production operations

- **Coherent management of the petroleum domain:** Prompt exploration is facilitated by a unified management of the petroleum domain which usually implies creation of a register and graticulation of the domain. Ideally, delimitation of blocks in Somalia shall take into account the Member States' territory, and the blocks shall be granted to diverse investors, to avoid Somali depending on a sole investor trusting the Somali territory. In this respect, maximum surface of blocks shall be set in the law as well as the maximum number of blocks that one investor may hold.
- **Minimum work requirements:** The law shall impose a minimum period to start exploration work. Usually practices is also that the investor has contractual commitment to perform minimum work program, which commitment is secured thanks to financial security the amount of which correspond to the estimate of the work to be performed, and thanks to sanctions, where such minimum work program is not performed, up to termination of the PSA. The Model PSA shall be aligned on such international practices.
- **Limitation in time:** A maximum exploration period shall be set in the petroleum law, as well as the principle under which exploration period may be renewed. In particular, where the investor did not perform the minimum work requirement, it shall not be entitled to renewal. The petroleum law and the model PSA shall be aligned on best international practices on this matter. Flexibility shall be set in the law for potential extension of the exploration period. The regulation shall further specify the maximum duration of such extension and the specific circumstances enabling for such extension.
- **From discovery to exploitation:** The law shall set various milestones with maximum period to reach such milestones to force the prompt appraisal of any discovery. The investor is then invited to submit a development plan which describes its project for the development of the commercial discovery. Approval of the development plan shall mark the beginning of the exploitation period. Such approval shall result from express decision of the public authority and shall not be deemed. This shall be set clearly in the petroleum law.
- **Specific rules relative to gas:** Apart from the Gas Retention Period which shall be set in the petroleum law rather than in the model PSA, the law shall impose that any development plan includes proposal for valuation and preventing flaring of the associated gas. The law shall also set the condition under which the public authority can have associated gas made available at a defined point.
- **Continuous and optimal exploitation:** The petroleum law shall set a maximum period to start development work and shall oblige the Contractor to reach commercial production, as defined in the development plan, by the date set in the development plan. Failure to comply with such obligation shall result in potential withdrawal of the petroleum rights. Exploitation shall not be interrupted without legitimate reasons. The Contractor shall provide the public authority with regular reports including estimate of production.
- **Annual work program:** Annual work program and budget shall be approved by the public authority. This can be done within the Management Committee. Cost incurred in addition to costs approved within the annual work program and budget shall not be considered as recoverable cost.

- **Management committee:** The role of the management committee and the rules for decision making in the Management Committee needs to be set with more clarity.
- **Standard of care and power of control of the public authority:** As under the 2008 Petroleum Law, the Contractor shall comply with Good Oil Field Practice and the public authority may order measures to the Contractor or sanction the wrong full behavior of the Contractor, including as the case may be through withdrawal of the Authorization. The cases for withdrawal shall be more precisely determined.

Health, safety and environment protection

- **Performance based policy:** The 2008 Petroleum Law is mainly in line with the performance based policy adopted by the best international practices. The Contractor is made responsible for any health, safety or environmental damages resulting from the petroleum operations as under the polluter pays principle. A principle of absolute liability of the Contractor shall nevertheless be set to allow for straight forward indemnification, together with an obligation for the investor to take out insurance. Various milestones at which risks assessment shall be compulsory shall also be set in the law.
- **Site rehabilitation:** As provided under the current Somali petroleum framework, the Contractor shall be under the obligation to decommission and rehabilitate the lands on which operations took place. For this purpose, the investor set a decommissioning plan which needs to be approved by the public authority. The scope of the rehabilitation shall be further specified. The decommissioning plan includes estimate of the cost of decommissioning works and the investor shall secure funding for such works. The law shall specify that decommissioning is required not only following exploitation but following any type of operations having impacts on the lands. The law shall also require that the reserve fund set to secure the funding of the decommissioning works be kept outside the accounts of the company and specify the basic rules for management of such fund.

Local content

- **Training for development of local capacities:** The law shall put responsibility on the Contractor to provide training and obtain results as determined within an annual training program, to be approved by the public authority. A minimum expenditure requirement in this respect shall be set at the regulatory level.
- **Prioritizing recourse to local goods, services and employees:** The conditions for preference of local goods, services and employees shall be more clearly set within the law. No preferential treatment shall be offered to local entities, goods or employees. Preference may only be given where condition and/or capacities are similar.
- **Agreement for development of local content:** Provisions in the Model PSA regarding local community benefit shall be amended. The investor shall have a payment obligation to a fund to be used for the development of local communities in accordance with the terms and conditions set in an agreement to be entered into with the representatives of the local communities.
- **Local market provisions:** As per the Contractor's obligation, under the Model PSA, to a minimum contribution to supply the Somali market, the public authority shall give sooner notice to the Contractor of the needs of the local market, to provide more visibility for the Contractor.

Part 3 - Investor's Main Concerns

Authorizations, Access and confidentiality

- **Access to the lands:** Further provisions shall be inserted within the petroleum law to guarantee the Contractor access to the lands, notably a general commitment from the public authority to make lands available, including taking measures such as expropriation or clearing of customary rights.
- **Access to the assets:** The law shall include a general provision against illegitimate expropriation of the contractor. The law shall also specify that the assets acquired for performance of the petroleum operations are the ownership of the contractor during the exploration phase but become ownership of the public authority during the exploitation phase. The Contractor shall nevertheless be given the right to freely use such assets for the purpose of its petroleum operations.
- **Confidentiality of the data:** The 2008 Petroleum Law is compliant with international practices with respect to the status of data. The public authority is the owner of the data, the Contractor can use the data, but there shall be no communication of data by either party without prior consent of the other party. A limit in time shall be set in the petroleum law with respect to this confidentiality obligation, which shall be the expiry of the PSA.

Right to monetize

- **Commercial discovery and approval of the development plan:** The public authority may not prevent the investor from developing a commercial discovery. Although the public authority shall expressly agree upon the development plan, it shall not unreasonably withhold its approval on such plan. The law shall also provide for potential recourse to a third party to settle issues as the case may be, which decision shall be binding on both parties.
- **Free sale of production and free disposal of the proceeds from such sale:** The petroleum law shall offer assurance to the Contractor that it will be able to export production and sale it abroad at market price. The investor also needs guarantee with respect to foreign exchange rules, notably that it will be able to keep proceeds of the sale of the production abroad.

Enforceability of the PSA

- **Applicable law:** Applicable shall remain the law of Somalia. Where the law of Somalia is silent, the principle of international commercial law shall apply.
- **Dispute resolution provisions:** Any dispute arising from or in relation to the PSA, including disputes in relation to interpretation, implementation or termination of the PSA, may be settled through arbitration. The PSA shall provide for a period of time during which the parties preliminary try to settle the dispute through negotiations. The PSA shall specify the rules applicable to arbitration. ICSID rules are recommended. English shall be preferred as language for arbitration as well as a neutral place of arbitration. It is recommended that the law clearly set that Somalia waives its immunity from execution.

- **Termination:** The public authority may only terminate the PSA for specific reasons listed in the law or the PSA and following notice and expiry of a period given to the Contractor to remedy. The investor shall be free to renounce to its rights at any time subject to performance of the minimum work program in exploration, and rehabilitation of the sites. No approval shall be required from the public authority.
- **Force majeure:** The Model PSA includes provisions for force majeure which are compliant with the best international practices and do not need to be modified.

Stability of the regime

- **Stabilization clause:** The petroleum law shall set that petroleum agreement can include stabilization clause which aims at maintaining the initial financial and economic balance of the agreement. The Model PSA includes provisions in this respect which are considered compliant with the best international practices, as they offer stability of the terms of the PSA and of the fiscal framework applicable at the time of entry into force of the PSA, together with mechanisms for compensation where any significant change arises.
- **Transition provisions:** Transitional measures need to be inserted in the new petroleum law to address the cases of the existing petroleum rights.

Part 4 - Financial and Fiscal Issues

The recommendations for updating the fiscal petroleum framework in Somalia are limited to upstream activities and are based on the principle that the new fiscal framework will need to address the absence of a comprehensive and currently enforceable legislation in Somalia mandating direct and indirect taxation of individuals or businesses.

The proposed fiscal framework is based on the following principles which reflect the objectives for the updated oil and gas fiscal framework in Somalia:

- ▶ Progressive taxation of petroleum upstream operations (i.e. taxation is proportionate to the profitability of the operations);
- ▶ Simple-to-administer regime;
- ▶ Hybrid regime: single source of petroleum legislation and fiscal terms (i.e. petroleum law) with some variables to be specified in a petroleum contract;
- ▶ Fiscal terms applicable to petroleum upstream operations will be solely the one envisaged by the petroleum law and the petroleum contract; no other taxes, fees or similar payments will be applicable to petroleum upstream operations;
- ▶ Attractive fiscal terms compared to the neighboring countries taking in account the frontier status of the Somalian petroleum opportunities.

The main changes recommended in the proposed framework include: i) the change in royalties (flat rates instead of the daily production/prices-based sliding scale), ii) increased cost recovery ceiling, iii) profit

production sharing based on an R-factor, a profitability ratio (instead of the daily production sliding scale), and iv) exception from any taxes and levies which are not specified in the petroleum law and the petroleum agreement. Each component of the proposed framework is discussed in the respective sections below.

Each individual component of the proposed fiscal framework should be considered and assessed in conjunction with all other fiscal terms representing the proposed fiscal framework, rather than on a stand-alone basis. The same principle applies with respect to assessing each individual component of fiscal regimes in the benchmark countries.

Valuation of petroleum

- The valuation provisions for crude oil and natural gas as currently addressed in the Model PSA are generally robust and could be used in the future, but could be detailed at the drafting stage to narrow down the valuation to an appropriate benchmark crude oil and gas.

Royalty

- The proposed framework includes royalty at flat rates (rather than the daily production/prices-based sliding scale), differentiated for gaseous and liquid hydrocarbons: 10% for crude oil and condensates, 5% for natural gas. Royalties are recommended to be a non-biddable fiscal term.

Cost recovery

- The proposed framework includes a unified cost recovery ceiling of 70% of available petroleum (rather than lower and differentiated ceilings for gaseous and liquid hydrocarbons). Cost recovery ceiling is recommended to be a non-biddable fiscal term.
- Within the cost recovery limit of 70%, the proposed cost recovery rules include 100% immediate write off for all categories of recoverable expenditure. Any financing cost, signature bonus, and foreign overhead cost in excess 1% of total recoverable costs should be clearly addressed to be non-recoverable.

Profit sharing

- **Basis for calculation:** The proposed framework includes sharing of profit production (the production remaining after royalty and cost recovery) based on the R-factor sliding scale (rather than the daily production/prices-based sliding scale).
- **R-factor formula:**

$$R \text{ Factor} = \frac{[\text{Cumulative Contractor (Cost Oil + Cost Gas + Profit Oil + Profit Gas)}]}{[\text{Cumulative Contractor (CAPEX + OPEX)}]}$$

It measures overall economics of the Contractor Group and not economics of individual parties to the project. The recommended formula is based on a notion that it is a transparent and easy-to-administer production sharing formula. It also helps mitigate any potential controversy surrounding the classification of expenditure as operating expenditure (OPEX) or capital expenditure (CAPEX) as both form the denominator.

- **R-factor thresholds:** The recommended threshold structure includes a pre-set rate until the R-factor reaches one (whereby 80% will be awarded to the Contractor), and a pre-set rate when

R-factor exceeds 2 (whereby 15% will be awarded to the Contractor). In between these thresholds, a linear equation is proposed.

Corporate income tax

- The recommendation is that corporate income tax at 35% rate will apply to the petroleum operations in the form of “tax paid” PSA, which may be more suitable for Somalia at its current state of general fiscal framework, instead of being payable directly by the Contractor, the corporate income tax will be factored into the Contractor’s share of profit oil and profit gas, with the tax paid from the public authority’s share of profit oil or profit gas.

Signature bonus

- The proposed framework includes signature bonus only (no production bonuses proposed because of their negative attributes from an investor’s standpoint). The signature bonus is proposed to be biddable with now a pre-set minimum of US\$ 200,000 and should be non-recoverable for cost recovery purposes.

Surface rentals

- The proposed framework includes surface rentals pre-set based on the acreage of blocks, and which are cost-recoverable. Considering the average large acreage of the blocks in Somalia, the recommendation is to keep the rental rate as currently envisaged: US\$10 per square kilometer during the exploration phase and US\$100 per square kilometer during the development and production phase.

Training contribution

- The proposed framework recommends doubling the training contribution to US\$200,000 (from US\$100,000) annually, with the contribution being recoverable.

Local community contribution

- The proposed framework retains the local community contribution but it is recommended to switch from a percentage formula to a lump sum mechanism due to the fact that the percentage formulae was having the same effect as an additional profit sharing to the public authority and a significant negative impact on the economics of a project. The recommendation is to set the contribution at US\$ 200,000, payable on an annual basis until the start of production, then increasing the annual contribution up to US\$ 500,000. This payment should be recoverable for cost recovery purposes.

Government participation

- The proposed framework retains the option for Somalia for direct participation in projects, through a single competent entity. It is recommended that the maximum interest that such competent authority may have is set to 25%.
- It is recommended that the competent entity’s interest is carried through exploration (meaning Somalia would not reimburse investor(s) for its percentage of exploration costs), and becomes full equity interest thereafter (meaning Somalia will contribute 100% of its share of costs after the exploration phase is completed). It is still advisable that Somalia carefully considers the

percentage it would opt for (within the 25%) based on its financial abilities at the time such a decision would need to be made, to avoid any controversy with investors.

Other tax matters

Taxation of capital gains

- The recommendation is that Somalia introduces a capital gains taxation arising from transactions where the value is derived by its natural resources, whether through a direct or indirect transfer of interest. The aim is to target only those capital gains which will result from cash payments.
- We propose the capital gains tax rate to be 20% on the difference between a sale price and a purchase price (i.e. historical costs).
- It is also recommended to introduce joint liability for a buyer, in case a seller fails to pay the capital gain due.

Customs duties

- The proposed framework includes full exemption for petroleum operations from customs duties, both from import and export duties and payments. This is generally in line with international practices applied to upstream projects by many countries. The recommendation is to provide such exemption throughout the project's life for fiscal stability and predictability purposes from investor's perspective.

Taxation of foreign subcontractors

- The recommendation is to introduce a withholding tax at moderate levels with separate rates for foreign and local subcontractors. The taxable basis for the withholding tax is proposed to be the gross remittance payable to the subcontractor, which is generally in line with international practice.
- The rate for foreign subcontractors is recommended to be set at 5%, and at 3% for local subcontractors with reasonable substance in Somalia to create an incentive for service companies to set up a legal presence in-country. For local subcontractors, the tax withheld by the Contractor should be eligible as a tax credit against their corporate income tax liability in Somalia.

Withholding tax on dividends and loans

- The proposed framework includes an exemption from withholding tax to loan interest due to the fact that it would otherwise ultimately increase project's costs; also the interest not being cost recoverable, the Contractor will not take advantages of any tax deduction. For the dividends, since operator's profits will be subject to material taxes, such profits may be exempt from taxation. Alternatively, a 10% withholding tax rate may be considered.

Personal income tax and social payments

- **Taxes payable by employees (whether directly or withheld by an employer):** The recommended approach is that both foreign and local employees remain subject to personal

income tax and social security contributions, as may be applicable under existing Somalian legislation. It is also recommended that companies remain liable to withhold and remit the applicable taxes as required.

- **Taxes payable by employer:** The recommended approach is that no contributions are payable by employers in respect of the personal income tax and social security contributions of its foreign employees while such contributions are still due by the employer for local employees in Somalia.

Other taxes and payments (other than those addressed)

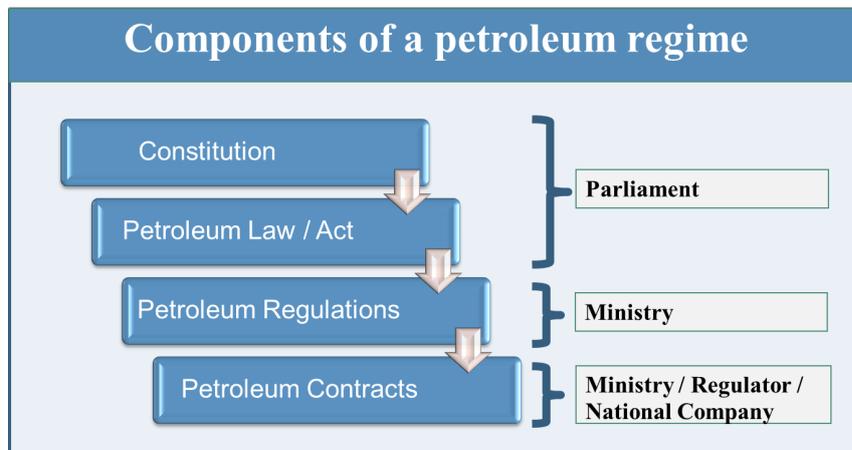
- There is legislation in place in Somalia which envisages various taxes and levies, such as excise tax, stamp tax, customs duties, and others, although such legislation might not be currently fully implemented in practice. Considering the objectives of the fiscal framework for petroleum operations in Somalia, it is recommended to exempt petroleum operations from any other taxes, levies or payments in any form other than those listed in the petroleum law and the petroleum contract (as listed above). This will contribute to proving investors with a clear visibility of the fiscal burden they should expect when undertaking petroleum operations in Somalia.

Comparative assessment of the proposed fiscal regime

- The proposed fiscal framework is competitive under low, medium and high oil price scenarios, compared to the peer countries, mainly Mozambique, Tanzania and Kenya as the countries which have most active developments in their petroleum sectors. It is also important to note that the proposed framework is progressive and also able to adjust to low oil prices which is very important for investors. The proposed framework is significantly more competitive than the current framework. The proposed fiscal framework delivers a competitive IRR, including under low oil price scenario.

PART 1 - INSTITUTIONAL ISSUES

A petroleum regime results from a set of different statutes, regulations and contracts that govern the petroleum operations (exploration, development and production) carried out in a given country. It generally consists of the following main elements: constitution, petroleum law, petroleum regulations and petroleum contracts.



A constitution is a country's basic law that is predominant in determining the separation of powers among the various legislative, executive and judicial branches of a country. In most countries, legislative authority concerning the realization and management of petroleum operations is vested in the legislature (Parliament). The constitution of some countries likewise makes direct mention of the ownership regime for petroleum. The constitution of federal countries usually also makes direct mention of the revenue sharing arrangements.

The petroleum law thus enacted by a country's legislature must be compliant with the constitution, including the allocation of legislative responsibilities, and subsequently the implementing regulations must be compliant with the petroleum law and the constitution.

The terms and conditions to which each investor is subject are stipulated by a petroleum contract that is concluded between (a) the relevant authorities of the country (petroleum Ministry and/or a regulatory agency and/or a national oil company ("NOC")); and (b) a Contractor and/or the NOC. Such a contract must be consistent with the provisions of the relevant petroleum law and its implementing regulations.

The petroleum legal framework of Somalia presents three characteristics which must be underlined and further analyzed:

1. The Provisional Constitution, the 2008 Petroleum Law and the Model PSA constitute a very flexible regime.
2. The Provisional Constitution is a well-developed and comprehensive document. However, the allocation of powers (and corresponding resources) between the FGS and the Member

States Governments is not set in the Provisional Constitution⁸ and the status of the natural resources is left open⁹.

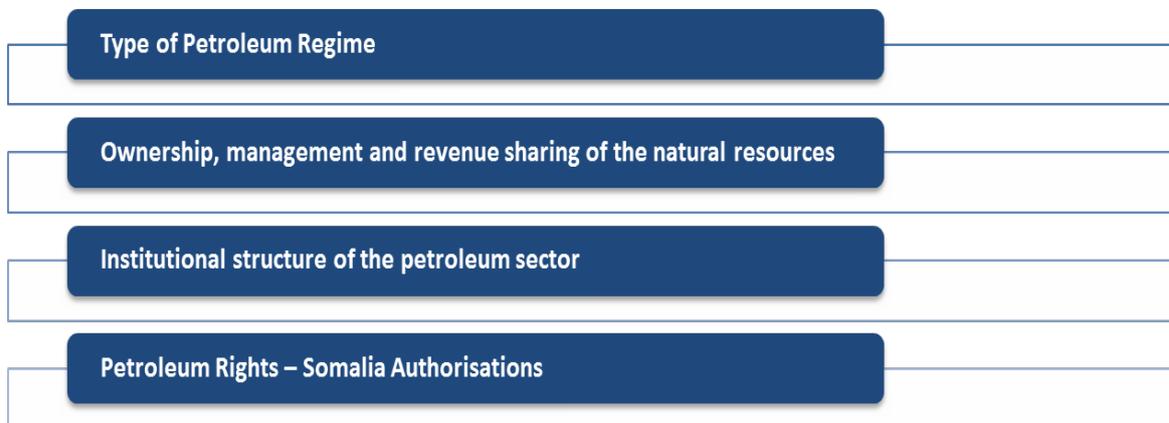
The Provisional Constitution calls for the negotiation of a separate agreement to be entered into between the FGS and the Member States on the constitutional provisions to govern natural resources. We understand the Constitution revision process and Consultative Process are currently reviewing the key provisions regarding natural resources to be inserted in the Constitution or any other agreed arrangement between the FGS and the Member States.

Reference in this report to the Allocation Agreement shall include any amendment of the Provisional Constitution and other agreement supplementing the Constitution as may be required to be entered into between the FGS and the Member States (the "**Allocation Agreement**")

With respect to natural resources (oil), the Allocation Agreement must deal with three main issues:

- the ownership of the natural resources;
 - the institutional structure of the petroleum sector; and
 - the petroleum revenues allocation mechanism.
3. The type of license or Authorization which may be granted to investors pursuant to the 2008 Petroleum Law is quite limited.

This **Part 1** will review and comment the following issues:



⁸ Article 54 of the Provisional Constitution : "*The allocation of powers and resources shall be negotiated and agreed upon by the Federal Government and the Federal Member States, except in matters concerning: (A) Foreign Affairs; (B) National Defence; (C) Citizenship and Immigration; (D) Monetary Policy, which shall be within the powers and responsibilities of the Federal Government.*"

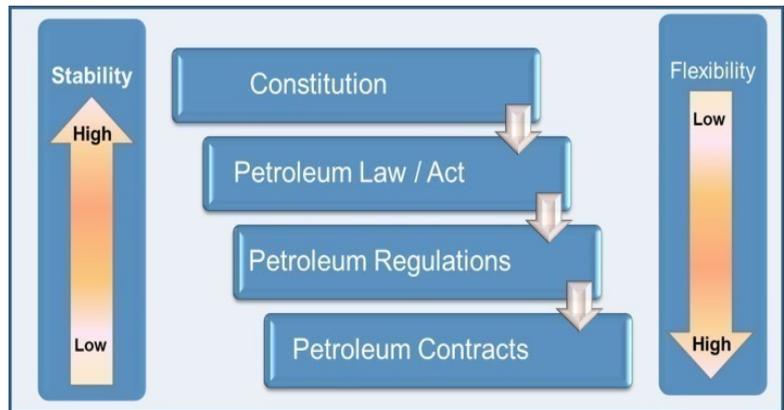
⁹ Article 44 of the Provisional Constitution : "*The allocation of the natural resources of the Federal Republic of Somalia shall be negotiated by, and agreed upon, by the Federal Government and the Federal Member States in accordance with this constitution.*"

1. TYPE OF PETROLEUM REGIME

1.1 General remarks

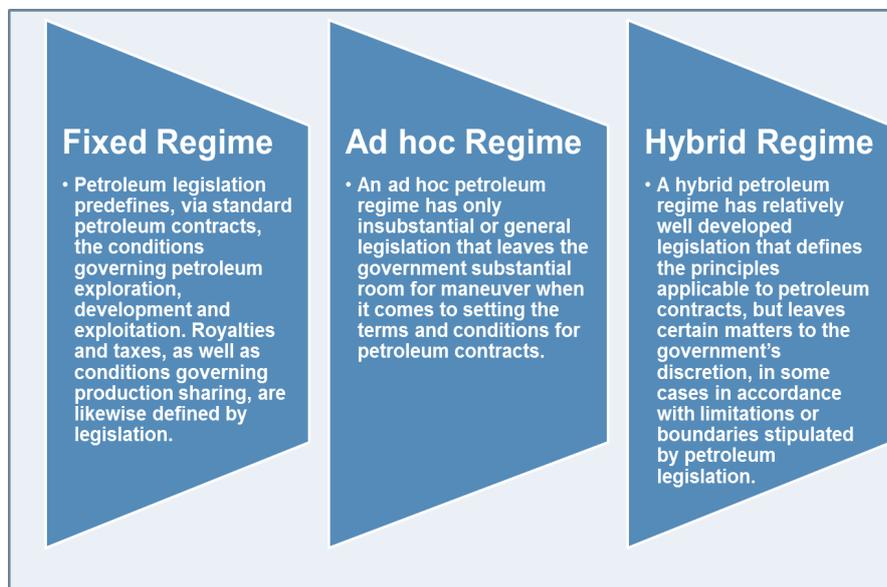
It is essential for a country setting its petroleum regime to determine the spread of its petroleum regime across all legislation, as well as petroleum exploration, development and production contracts, and to do so in a balanced manner taking account of the need for a stable yet flexible petroleum regime.

The greater the proportion of petroleum regime provisions that are promulgated by the constitution and the petroleum law, the more stable the petroleum regime will be. Conversely, the greater the proportion of petroleum regime provisions that are promulgated by petroleum regulations and contracts, the more flexible the petroleum regime will be.



Indeed, amending a constitution usually entails a lengthy process, and amending a petroleum law requires a formal administrative process culminating in a parliamentary vote. Amending the provisions of petroleum regulations however, involves a more flexible process including promulgation of new regulations by the Ministry of petroleum. Amending a petroleum contract merely requires that the parties agree on the desired changes, even if certain formalities as regards to the coming into effect and/or ratification may be mandatory pursuant to the petroleum law and/or its implementing regulations.

Against this backdrop, three classes of petroleum regimes can be said to exist: a fixed regime, an ad hoc regime and a hybrid regime.



As terms of the petroleum contract are included in the law under a fixed petroleum regime, such type of regime strengthens the public authority's position during petroleum contract negotiations. It also provides protection against abuse of administrative discretion and greater administrative simplicity. Under an *ad hoc* petroleum regime, the public authority benefits from considerable flexibility in terms of adapting the terms and conditions of a statutory petroleum contract. This situation can potentially weaken the public authority's position when negotiating with investors, and raise the risk of abuse of administrative discretion.

A fixed petroleum regime offers little flexibility and, if circumstances change, can result in a country missing out on opportunities given the lengthy process for amending petroleum legislation. Another problem with rigid systems of this nature is that they may prove to be incompatible with market conditions and the situation in the country *per se*, particularly in non-producing countries or countries lacking proven petroleum potential. Moreover, a petroleum regime applies uniformly to promising and less promising sites alike, thus making it difficult to strike a balance that allows for concurrent management of these various situations. A fixed petroleum regime may either convey the impression of being unduly hard on investors, or it may convey the reverse, i.e. that it is excessively accommodating toward investors. To remedy such drawbacks, a fixed petroleum regime may insert terms with mechanisms for automatic variation of applicable terms to petroleum operations. This however supposes identifying exactly the specific terms that will need to vary depending on evolution of the situation in the country.

Under a hybrid petroleum regime the petroleum law sets principles for conduct of petroleum operations in the law and leaves discretion to the administration. However, unlike in *ad hoc* regime, discretion left to the administration is limited to specific items and within a specified framework set in the law. Hybrid petroleum regime can therefore be a "strong" regime, as under a fixed regime, but will nevertheless keep a certain flexibility which will allow terms and conditions in specific circumstances or variable circumstances to be adapted.

In our view, the best solution is a hybrid regime, particularly as Somalia is a non-producing country. The petroleum regime can subsequently, after the initial phase of exploration and development, be developed through petroleum legislation which will become increasingly detailed.

1.2 Analysis of the existing Somalia Petroleum legal framework

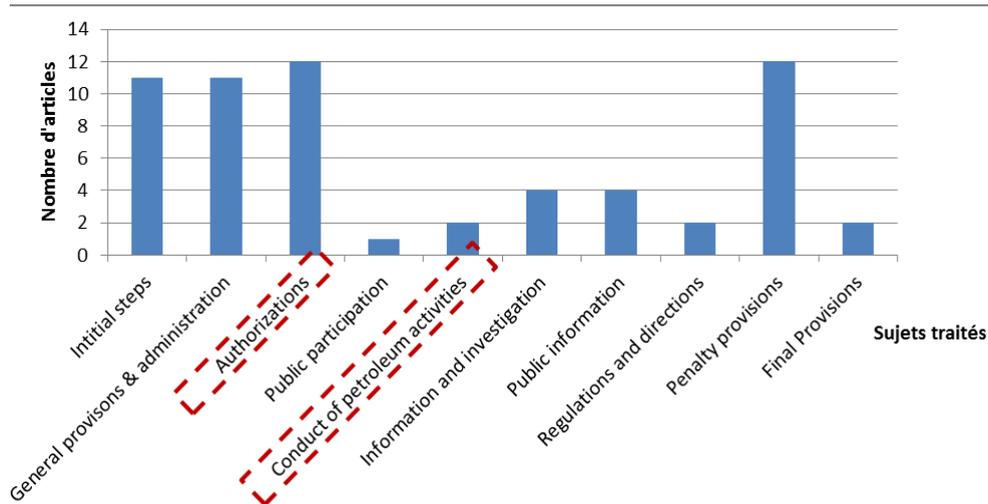
Considering the four (4) components of any petroleum regime, the Somali petroleum legal framework, as described in Section 2 of the Introduction to this Report, pertains to the class of "*ad hoc*" petroleum regime granting considerable flexibility to the authorities in terms of adapting the terms and conditions of a petroleum contract.

1.2.1 The Provisional Constitution contains only few provisions dealing with the natural resources. It mainly invites the FGS and the Member States to enter an agreement for the allocation of the natural resources¹⁰.

1.2.2 Compared to other recent petroleum laws the 2008 Petroleum Law is rather a short one (60 articles)¹¹ with only few provisions dealing with the petroleum operations.

¹⁰ Article 44 of the Provisional Constitution provides that "*the allocation of the natural resources shall be negotiated by, and agreed upon, by the Federal Government and the Federal Member States in accordance with this Constitution.*"

¹¹ Kenya's petroleum law (5th August, 2015) contains 130 articles; Tanzania's petroleum law (29th May 2015) contains 260 articles (includes midstream and downstream activities); Uganda's petroleum law (4th April 2003) contains 191 articles (upstream activities only).



Chapter II of the 2008 Petroleum Law dealing mainly with the administrative organization is well developed. The same applies to the penalty provisions (Chapter IX). However the chapters dealing with the Authorizations (Chapter III, 12 articles) and the conduct of petroleum operations (Chapter V, 2 articles) are rather brief in comparison to other petroleum laws. The provisions dealing with the production sharing agreement¹² are not detailed, which leaves a lot of power to the Minister in charge of petroleum. Indeed, the 2008 Petroleum Law does not set any minimum with respect to the royalties, the recovery of petroleum costs nor the profit sharing mechanisms.

1.2.3 The legal status of the Model PSA is not known. It may have been adopted through a ministerial regulation and consequently the Minister of Petroleum.

The investor may have a lot of flexibility when negotiating its terms and conditions. Indeed, provisions of the PSA which are compulsory under the 2008 Petroleum Law are quite limited. Article 24.6 of the 2008 Petroleum Law states that the PSA shall include provisions addressing the following matters:

- (a) a minimum work program with respect to the exploration phase;
- (b) relinquishment obligations during the exploration phase;
- (c) financial terms relating to the royalties (if any) and the sharing of the production between the Contractor and the FGS; and, "if appropriate" other financial elements such as signature and production bonuses;
- (d) environmental provisions;
- (e) obligations to supply the domestic market;
- (f) training and hiring of Somali citizens;
- (g) preference for the supply of Somali-sourced goods and services;
- (h) "if appropriate", assurances of financial and contractual stability; and
- (i) international arbitration.

¹² Only one article (article 24 of the 2008 Petroleum Law).

The Model PSA meets these requirements and is drafted in accordance with the 2008 Petroleum Law "*A contractor shall, at all times and in regard of all things, comply with its obligations under the Law. No provision of this Agreement [the Model PSA] shall excuse the Contractor from so complying, nor derogate from any right or privilege of the [Federal] Government under the Law.*"¹³

The Consultant notes that the Model PSA refers to the Federal Government for decision making or supervision of the operations on the public authority's hand. This notion includes "*other agencies, from time to time, responsible for the administration of Petroleum*".

- 1.2.4** For the time being, no regulation implementing or supplementing the 2008 Petroleum Law has yet been adopted. Pursuant to the Petroleum Law, the Minister of Petroleum has the authority to issue regulations with respect to the management of petroleum operations "*as recommended by the Somalia Petroleum Authority.*"¹⁴

1.3 Recommendations

The Consultant recommends moving the current petroleum regime to a hybrid regime with a more developed legislation, in particular with respect to (i) the Authorizations and (ii) the conduct of the petroleum operations.

The various recommendations in this Report identify the level at which various provisions shall be inserted in the petroleum regime to create this hybrid regime. Such regime will aim at putting in place a sufficient set of rules to create a strong position of the public authority in negotiations and management of petroleum operations, while preserving flexibility for specific circumstances or evolutions.

The Consultant also recommends the official adoption of a model PSA, at it shall be specified in the law. This will set official basis for negotiations of the PSAs which will ease the position of Somalia in the negotiations, provide protection against abuse of administrative discretion, and will also ease management of petroleum operations through simplified administrative process. In order to give sufficient status and still preserve a certain flexibility of the regime, the Consultant recommends that such model PSA be adopted at the regulatory level, by the relevant body as determined in the petroleum law, as revised following the Consultative Process.

¹³ Article 2.1(a) of the Model PSA.

¹⁴ Article 18.1.2 of the 2008 Petroleum Law.

2. OWNERSHIP, MANAGEMENT AND REVENUE SHARING OF THE NATURAL RESOURCES

We understand there is a preliminary agreement between the FGS and the Member States on the fact that the people of Somalia or Somali nation are the owner of the natural resources.

For the time being, no consensus has been reached yet on the level at which the petroleum regime shall be defined nor on the level at which the management of natural resources shall be vested in Somalia.

The Consultant and EY Counsel hereby refer to the Consultative Process as per the decision on the level at which the petroleum regime shall be set.

All the same, the FGS and the Member States' authorities shall reach an agreement, in the Consultative Process, on the bodies, roles and functions, for the management of the natural resources in Somalia.

The Consultant and EY Counsel underline here the importance of setting clearly such bodies, roles and functions to avoid potential future disputes. While discussing these issues, the FGS and the Member States' authorities shall keep in mind the need of efficient management of the petroleum sector and the necessary implication of the Member States in the management of the natural resources.

3. INSTITUTIONAL STRUCTURE OF THE PETROLEUM SECTOR

A petroleum regime needs to define clearly which authority or agency is in charge of (i) setting and implementing petroleum policy; (ii) granting petroleum rights and overseeing petroleum contracts, including acting as repository and interpreter of technical reports and data; and (iii) verifying compliance with the applicable regulations, including in the technical, financial, health, safety, and environmental spheres.

The Consultant and EY Counsel understand this is to be done within the Consultative Process and will result in the Allocation Agreement, which will also have to determine the institutions in charge for the petroleum sector and their respective roles.

Mainly there are two approaches in setting the institutional structure of the petroleum sector in a federal country, such as Somalia:

- the centralized approach

Under this approach, the power for management of the petroleum sector in the entire territory of the federation is vested in the hand of the FGS. This approach has the advantage of keeping the institutional structure of the sector simple and avoiding superposition of bodies for the same roles and functions which will result most probably in future disputes. In a purely centralized approach nevertheless the Member State are left aside for management of the natural resources. Variations are nonetheless possible to allow implication of the Member States in the management of the petroleum sector.

- the decentralized approach

Under this approach, the power for management of the petroleum sector is vested in the hand of the Member State concerned with the specific operations to be conducted on its territory. This approach allows a direct implication of each and any Member States in such management. It nevertheless requires a high level of staff resources to allow proper management in each Member State and the country then does not appear as a unity to foreign investor, thus losing attractiveness. Such approach also most often implies, on the revenue sharing, separate benefits from the petroleum operations in each of the Member States, whereas it is usually in the advantage of the whole country to share existing revenue. Therefore variations are usually inserted to allow harmonization or unitized supervisions of the management of the natural resources.

The 2008 Petroleum Law sets a centralized approach structure of the petroleum sector in Somalia. The 2008 Petroleum Law also includes elements to allow implication of the Member States.

In line with international practices in a centralized approach, the 2008 Petroleum Law entrusts the below listed duties and responsibility respectively to the Minister overseeing the petroleum sector (the "**Minister of Petroleum**") and the Somali Petroleum Authority ("**SPA**"):

Allocation of functions and powers in the 2008 Petroleum Law	
Minister of Petroleum <i>Strategy and regulations</i>	SPA <i>Control and regulatory functions</i>
<ul style="list-style-type: none"> - makes decisions on strategies, plans and policies for the development of the petroleum industry; - is in charge of issuing regulations with respect to the management of the petroleum activities, making decision on policies forms of cooperation with foreign entities and establishing policies as regards petroleum exportation; the Minister makes regulations based on advice and recommendation of the SPA; - signs each production agreement based on recommendation from the SPA. 	<ul style="list-style-type: none"> - grants and terminates the Authorizations, including the PSAs; - controls petroleum activities: <ul style="list-style-type: none"> ▪ It verifies compliance of the laws, other regulatory statutes and the PSAs by the petroleum operators (with a power of sanction); ▪ It shall approve a number of operations affecting the PSAs.

The status of the SPA is not clearly defined. The 2008 Petroleum Law merely indicates that "*the SPA shall be formed [...] by the [Federal] Government*"¹⁵. At the moment, the SPA has not yet been established.

The Minister of Petroleum has, pursuant to the 2008 Petroleum Law, the authority to enter into a PSA, upon recommendation of the SPA. "*Each Production Sharing Agreement shall be signed by the Minister, based on a recommendation of the SPA.*"¹⁶

15 Article 19.2 of the 2008 Petroleum Law.

16 Article 24.1 of the 2008 Petroleum Law.

Additionally, under the 2008 Petroleum Law, the SPA is under the obligation to publish (i) the main provisions of the signed PSAs and (ii) detail on and reasons for exemption or variation from conditions of a PSA in the law or from the required tender process.

The 2008 Petroleum Law also establishes the Somalia Petroleum Corporation ("**SPC**") to allow for Somalia investments in petroleum operations. The SPC is entitled to exercise the 30% participation right stated in the 2008 Petroleum Law¹⁷ and to acquire an Authorization (PSA)¹⁸. Such participation is part of the fiscal tools of a country but also represent a way for a country to increase its influence in the petroleum sector and build capacities.

This type of participation has raised significant issues in other countries, in terms of corruption and transparency.

The Consultant recommends maintaining a SPC's participation. This SPC's participation shall however come with strict limitation of the role of the SPC which shall remain a purely commercial entity with no regulatory powers either for the granting of rights or the supervision of the petroleum activities. This approach will help avoiding any conflict of interests. It is important to keep the SPC outside of regulatory functions.

The 2008 Petroleum Law includes provisions to allow implication of the region in the management of petroleum operations and direct return for regions of the petroleum activities, as follows:

- The 2008 Petroleum Law specifies that the Minister of Petroleum may approve opening of a branch/representative offices in some of the Member States where petroleum operations are developed or may be developed.

The SPA's main office could be located in any city of the country.

The 2008 Petroleum Law also refers to the right of the Member States to participate in petroleum operations through regional State-Owned Companies ("**SOC**")¹⁹. A SOC shall be entitled to a 10% maximum participation in petroleum exploitation where the development area is located in their own territory.

Together with the SPC's participation, the NOC's participation can reach up to 40%, which the Consultant and EY Counsel believe is rather on the high side on an international basis. The level of NOC's participation shall be reduced to keep the NOC with no minority power of blockage.

As to the relevance of these elements inserted in the 2008 Petroleum Law to enable implication of the Member States, or the suitability of the 2008 Petroleum Law's approach, the Consultant and EY Counsel refer to discussions driven during the Consultative Process, which shall result in determination of the relevant approach to be adopted and, consequently, in the definition of the competent authorities and their respective roles and functions.

¹⁷ Article 35 of the 2008 Petroleum Law.

¹⁸ Article 20.2 of the 2008 Petroleum Law.

¹⁹ Article 35 of the 2008 Petroleum Law.

The present report refers to "competent authorities" whenever a control or specific action is required from the host country.

4. PETROLEUM RIGHTS: SOMALIA AUTHORIZATIONS

In accordance with the common international practices, petroleum operations may only be carried out under the relevant petroleum licenses granted by the Host Government.

The 2008 Petroleum Law sets three types of Authorizations:

- (a) Reconnaissance Authorization which grants the right to perform some exploratory works (excluding any drilling) in a specified area;
- (b) Production Sharing Agreement which grants the right to conduct all types of petroleum operations, in a specified area, including recovery of petroleum where a discovery is made; and
- (c) Surface Access Authorization which grants the right to construct, install and operate facilities and installations as well as other works as specified in the Authorization in a specified area.

The legal regime of each Authorization is very briefly set under the 2008 Petroleum Law. Indeed, no indication is given with respect to their duration, surface area, renewal conditions or obligations related thereto. Under the current petroleum regime, these elements are left to be dealt with within the Authorization.

Developing such regime, notably with respect to PSA through an officially adopted model PSA as recommended under **Section 1.3** above, would allow public authorities to have a better control over the petroleum operations. A balance shall be found between the current approach, favoring flexibility of the petroleum regime, and a more stringent approach which would consist in inserting detailed provisions in the petroleum law.

Precisions on the regime of each of these Authorizations will also imply precisions on petroleum operations governed under the law, which means clarification on the scope of the petroleum law.

4.1 Reconnaissance Authorization

This type of authorization is found in most petroleum regime around the world. It authorizes an investor to carry out "*geological, geophysical, geochemical and geotechnical surveys in the Authorized Area*", which correspond to the works and survey usually considered as prospection works. Such works are superficial which enable the company to assess the potential interest of a specified area. The drilling of a well is expressly excluded²⁰.

The regime for such Authorization sets under the 2008 Petroleum Law is in line with international practices. It imposes to the holder regular reports on activities. The holder does not commit to a specific work program as under the PSA and adequately such Authorization does not grant the holder of the Authorization any preferential right or right to enter into a PSA.

²⁰ See Article 23.2.3 of the 2008 Petroleum Law.

The 2008 Petroleum Law however does not set the duration of such Authorization and some concerns may arise for the contractors of PSAs due to contradictory provisions. It stems from the provisions of Articles 23.3, 24.3.1 and 25.1.2 of the 2008 Petroleum Law that, although the PSA grants “*the exclusive right to conduct petroleum operations in the Contract Area*”, the SPA may still grant a Reconnaissance Authorization on such area, as well as a Surface Access Authorization, as long as (i) with respect to Reconnaissance Authorization, it notifies to the holder of the PSA such granting, and (ii) with respect to Surface Access Authorization, it takes into account the submissions made by the Contractor.

Pursuant to international practices, no Reconnaissance Authorization shall be granted on areas where a PSA has been granted. It is also usually set in the petroleum law, that where a PSA is entered into on a specified area, the existing Reconnaissance Authorizations expire. In this context, the law may however entitle the holder of the Reconnaissance Authorization to prior notification of the process for granting of a PSA on the concerned area and may invite the Reconnaissance Authorization holder to participate to a competitive tender, or submit concurrent offer.

With respect to Surface Access Authorization, it shall not be granted on any contract area of a PSA, and no Reconnaissance Authorization shall be granted on the area of a Surface Access Authorization, unless where there is no interference with the previous existing rights. However there shall be no limitation to the granting of a Surface Access Authorization on the area of a Reconnaissance Authorization, but for a prior notification.

Recommendation: The Consultant recommends that, with respect to the Reconnaissance Authorization, a maximum duration be set in the petroleum law (for example 1 year renewable).

The Consultant also recommends that the drafting of the articles relative to the granting of Reconnaissance Authorization and Surface Access Authorization on areas where other Authorizations, including PSA, are already granted, be reviewed to insert the above described best practices.

4.2 PSA

Under the 2008 Petroleum Law, investor may carry out all types of Petroleum Operations on specific area only pursuant to a production sharing agreement (a "PSA") entered into between the Minister of Petroleum and a Contractor. In particular, an investor may recover petroleum in Somalia only under a PSA.

4.2.1 The PSA appears a suitable choice of petroleum contract for Somalia.

It is the most commonly used or authorized form of petroleum contract in similar jurisdictions. For instance, it is used in the following 15 countries throughout Africa: Angola, Benin, Cameroon, Congo, Côte d'Ivoire, Egypt, Gabon, Equatorial Guinea, Libya (hybrid PSA), Mauritania, Nigeria, Niger, DRC, Sudan, and Chad.

It also constitutes a balanced contract for the performance of petroleum operations, for both the Host Government and the Contractors. The PSA is usually presented as offering a higher level of control of the petroleum operations than under the previously most used type of petroleum contract, the concession. This is mainly due to control by the authorities of the level of expenditures in the light of determination of the cost oil, and profit oil; whereas in the concession agreements the Host Government's rental is not related to the level of expenditures, but rather

to the sole price of extracted oil, through proportional royalty. The PSA is however more attractive than the service agreement to investor, which allow the same kind of control on petroleum. Under the service agreement the compensation for petroleum services may indeed not be related to the costs incurred by the investor to make the discovery and to develop such discovery.

Finally, and not least, it is also the currently used type of petroleum agreement in Somalia. The administration has used it for a certain period of time and therefore is much better trained to control petroleum operation under such regime.

Recommendation: The Consultant recommends maintaining the PSA as the petroleum contract to be used in Somalia.

4.2.2 Some of the key elements of the PSA must be set within the petroleum law and a model PSA to be adopted at the regulatory level to complement the law. The main principles shall be set in the petroleum law, as revised following the Consultative Process. The petroleum law shall then refer to a model PSA to be adopted by the relevant body as determined in the revised petroleum law, with respect to the detailed terms and conditions of such principles. This approach will allow certain terms to vary depending on the context of petroleum operations, but will also limit such variations within a specific range of applicable terms as set within the petroleum law, and model PSA. As the case may be the model PSA may as well evolve, to take into account new context (price, discoveries...). Such revision will be limited to the terms of the applicable petroleum law.

Those key elements are as follows:

- (a) **Duration:** the maximum duration of the exploration and production phases must be set in the petroleum law. Different periods may be specified depending on the location of the contractual area (on-shore, offshore and deep/ultra-deep offshore). The duration of the production period shall be computed from the date of approval by the competent authority of the development plan and not from the date on which the first commercial production occurs²¹ (see **Sections 2.1.3.1, 2.2.2 and 2.3.1 of Part 2** below).
- (b) **Approval of development plan:** the law shall specify that the Contractor shall not conduct exploitation operations without prior approval of the development plan by the competent authority which shall include specific elements to be listed in the PSA. The law shall nevertheless refer to the main elements to be included in the Development Plan such as feasibility study, environmental impact assessment report and related plan for management of environmental issues, plan for evacuation of petroleum (and related Surface Access Authorization that will be required) and plan for management of gas (see **Section 4.3.2 of Part 1 and Sections 2.2.2, 2.2.3 and 3.1 of Part 2** below).
- (c) **Local representation:** the level of requirement for local representation of the Contractor shall be set within the petroleum law rather than within the PSA (see **Section 1.1.2 of Part 2** below).
- (d) **Milestones for appraisal of a discovery:** the law shall set the minimum milestones from the appraisal of a discovery and the maximum period for performance of such milestones, in particular, the maximum period to declare commerciality of a discovery. Where the Contractor does not declare commerciality of a discovery within such period, it shall be

²¹ See Article 3.3 (a) of the Model PSA.

considered renouncing to such discovery and it may be required to relinquish the related area. The law may provide for potential extension for further appraisal. Such extension shall however be kept as restrictive as necessary (see **Section 2.2 of Part 2** below).

- (e) **Development works and first production:** the law shall specify a maximum period during which the Contractor shall start development works to achieve first commercial production as soon as possible. The law could set that failure to start development within such period will be considered as a case for termination of the PSA (see **Section 2.3.1 of Part 2** below).
- (f) **Minimum and maximum fiscal / financial terms:** the law shall set the minimum and maximum fiscal terms including the minimum signature bonus and maximum SPC participation as proposed below (see **Part 4**).
- (g) **Specific conditions with respect to NOC's participation:** the conditions for the NOC's participation including the maximum 25% participation interest, the principle of carried interest during exploration only and the timing for exercise of the NOC's option to acquire a participation shall be inserted into the petroleum law. (see **Section 114.3 of Part 4** below); and
- (h) **Conditions for preference to national goods, services and employees:** the conditions for preference of nationals over foreigners with respect to procurement of goods and services and with respect to employment shall be set within the law as the minimum requirements in this respect which will be complemented through subsequent regulation (see **Section 4.3 of Part 2** below).

4.3 Surface Access Authorization and related issues

4.3.1 Surface Access Authorization

The Surface Access Authorization aims at authorizing an investor to “*construct, install and operate structures, facilities and installations and carry out other works as specified in the Authorization in the authorized area*”, but not “*to drill a Well*”²².

Such authorization is not usually found under petroleum laws or regulations. This Authorization is all the more surprising that the operations it is giving permission to perform are not related to petroleum.

As such Authorization is provided in the petroleum law, it has been assumed, and this has been confirmed during the kick-off workshop in Nairobi, that the type of operations to be performed under the Surface Access Authorization shall be related to Petroleum Operations.

Recommendation: It shall be specified the Surface Access Authorization's holder will be entitled to perform the Petroleum Operations listed under point (iii) of the definition, meaning only such activities “*for the development, production and export of Petroleum*”, that is to say related / ancillary activities to the main petroleum operations listed under point (ii) of the definition.

It shall be clarified that a Surface Access Authorization may be granted either to the holder of a PSA (see **Section 4.3.2 of this Part**) or be granted to a third person. In the first case, the

²² Article 25.2 of the 2008 Petroleum Law.

operations conducted under the Surface Access Authorization for transportation of production arising out of the Contractor’s contract area, will be considered upstream activities, up to the Field Export Point as defined in the Model PSA (see **Section 4.3.3 of this Part**). In the second case, transportation activities will be considered mid-stream operations.

The law shall also specify the conditions under which the said infrastructure or equipment shall be operated, and access to third party shall be granted. The law shall notably specify the duration of such Authorization, the status of ownership of the concerned infrastructures, their potential transfer to the competent authority and the fiscal regime to apply to such Authorization, as the case may be. Such Surface Access Authorization shall be granted upon presentation of a detailed plan for construction, installation and operation of the concerned infrastructures. Such plan shall include as per any development plan, environmental assessment of the impact of such infrastructures and plans for mitigation of such impacts and rehabilitation of the lands. A model Surface Access Authorization may also be drafted and adopted as a regulation by the Minister.

The petroleum law shall specify terms of a Surface Access Authorization where it is granted in relation with a PSA, notably the possibility to recover the costs related to such infrastructures from oil to be produced on the contract area and the main terms and conditions for the third party access to infrastructures (including guarantee to the Contractor that such access will not jeopardize its ability to perform its petroleum operations).

4.3.2 Interaction with the PSA

The Model PSA defines Petroleum Operations as “*any activity authorized by the [Federal] Government hereunder and includes: (a) the exploration for, development and production of Petroleum in the Contract Area, and the export of that Petroleum from the Contract Area; (b) the construction, installation and operation of structures, facilities, installations, equipment and other property, and the carrying out of other works, necessary for the purposes mentioned in § (a) above; (c) Decommissioning; and (d) the marketing of Petroleum produced from the Contract Area*”.

It appears from this definition in the Model PSA that the Contractor may perform petroleum operations outside the contract area, where such operations are related to export of the Petroleum that it produces. In this context, it seems that the Contractor does not need to be granted a Surface Access Authorization to perform such operations, even outside the contract area.

This is however not clearly stated. Moreover, the Contractor is requested to give third party access right to infrastructure it installs and operates, where additional capacities remain available. In this context, the Contractor may have to export petroleum produced on another contract area by another Contractor. Such activity is not permitted under the Model PSA and would then require a Surface Access Authorization.

Recommendation: The petroleum law shall make clear that a Contractor, when requesting the authorization to pursue exploitation operations following a discovery, and submitting a development plan, shall also include a plan for construction and operation of related infrastructures, facilities, installations, equipment and other properties, that are necessary for exportation of petroleum from the contract area. Approval of the development plan (see **Section 2.2.2 of Part 2**) containing such plan shall be deemed granting of the relevant Surface Access Authorization in relation to such related infrastructure.

4.3.3 Scope of the Petroleum Law

The 2008 Petroleum Law limits the scope of the law to Petroleum Operations²³.

Petroleum Operations are defined under the 2008 Petroleum Law as : “*activities for the purposes of : (i) prospecting for Petroleum; (ii) exploration for, development, production, sale or export of Petroleum; or (iii) construction, installation or operation of any structures, facilities or installations for the development, production and export of Petroleum, or decommissioning or removal of any structure, facility or installation*”.

The two first points of this definition are usual in a petroleum law; they clearly refer to main upstream activities. Activities listed in point (iii) are also usually included into the upstream petroleum operations, as long as they are related or auxiliary operations to the main upstream operations (point (i) and (ii) of the definition of Petroleum Operations), meaning when they are performed by the Contractor under a PSA.

The definition of Petroleum Operations does not however enable to picture the exact point at which activities are no longer considered upstream operations and start being regarded as mid- or downstream operations.

Recommendations: The Consultant recommends specifying the various notions used under the definition of Petroleum Operations and include in these definitions elements to set the exact point at which activities are no longer considered upstream operations and start being regarded as mid- or downstream operations.

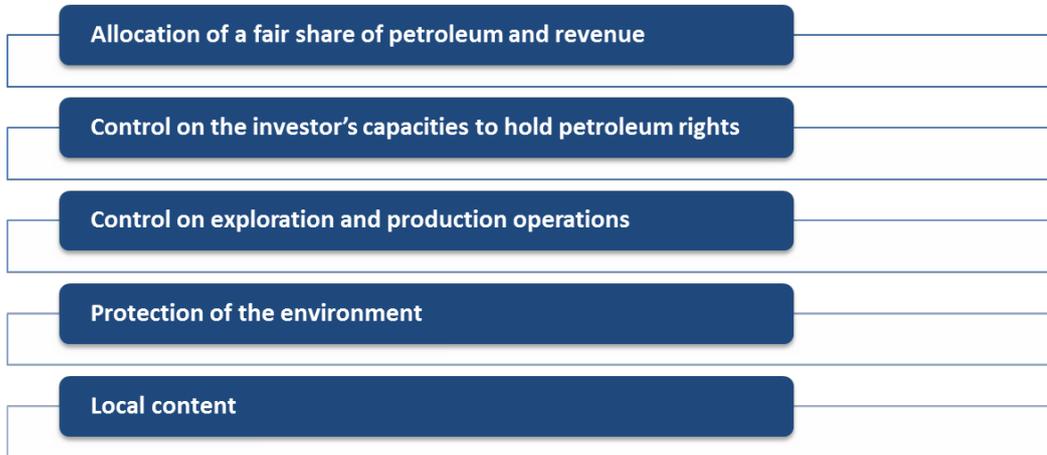
The 2008 Petroleum Law refers to the notion of sale and export of Petroleum. It shall be made clear that such activities are conducted consequently to production, and that they include storage and transportation of the petroleum, as may be required, up to a certain point. Most legislation uses the notion of gross-consumption point, and refers to marketing activities instead of exportation activities. Indeed, it is in the interest of Somalia that Petroleum may not merely be exported but also be sold locally. The notion of gross-consumption point could correspond to the notion of Field Export Point in the Model PSA which refers to a subsequent agreement between the parties, “*in an approved Development Plan*”. Indeed, in practice, the exact point of gross-consumption is set at the time of determination of the development plan, depending on each project specific circumstances.

The Consultant also recommends that other notions used in the definition of Petroleum Operations, such as the notion of production be clarified. It shall be specified that such notion refers to extraction, as well as treatment of hydrocarbons on site, which shall be defined as well, to separate such treatment activity from other activities that are usually considered mid-stream operations, such a refining activities.

23 Article 15.1 of the 2008 Petroleum Law: “*This Law applies to Petroleum Operations*”.

PART 2 - PUBLIC AUTHORITY'S MAIN CONCERNS

The Public Authority's main concerns which need to be dealt with in a petroleum regime can be summarized as follows:



This **Part 2** is structured in such a way as to check whether the current Somali petroleum regime properly addresses each of the public authority's main concern which are commonly dealt with in petroleum regimes. Where the Consultant identifies area of update, it provides recommendations to take into account international practices of the various host countries.

The first main concern of the public authority, the allocation of a fair share of petroleum and revenue, is treated together with fiscal issues under **Part 4** below.

1. CONTROL OF THE INVESTOR CAPACITIES TO HOLD PETROLEUM RIGHTS

The control of the investor aims at verifying before granting any petroleum rights and during the course of the operations that the investor is able to properly perform the petroleum operations it commits to. In this respect, the authorities shall set (i) the qualifications required from the holder of petroleum rights, (ii) a transparent selection process, and (iii) control and/or information processes on transfer of petroleum rights and specific transactions affecting the investor.

1.1 Required qualifications of a petroleum right holder

The competent authority shall verify, in the process for granting any petroleum rights, that the investor possesses sufficient capacities to perform petroleum operations it commits to with respect to the requested petroleum rights. The investor shall also maintain such capacities. The public authority also imposes the petroleum right holder to be a commercial entity with a minimum local representation requirement.

1.1.1 Technical and financial capacities

With respect to PSAs, the 2008 Petroleum Law is in compliance with international practices, since they require that only investors having demonstrated that they possess the necessary technical and financial capacities may be authorized to perform petroleum operations.

The 2008 Petroleum Law sets, in this respect, the requirement for technical and financial capacities to perform petroleum operations²⁴. The law does not however expressly set such requirement (i) with respect to other Authorizations²⁵, nor (ii) with respect to transfer of Authorizations, or rights and obligations arising from an Authorization, or transfer resulting in a change of control²⁶ or change of operator. This requirement, with respect to point (ii) above is set in the Model PSA²⁷.

Recommendation: The Consultant recommends that the updated petroleum law includes an express requirement for sufficient technical and financial capacities from any person to perform any type of petroleum operations.

Specific documents shall be required from the investor to assess its technical and financial capacities. These documents are usually detailed in the petroleum regulation together with the precise process for granting of petroleum rights. (see **Section 1.2** below)

In particular, technical and financial capacities shall be assessed depending on the specificities of the concerned area (onshore, offshore, deep offshore) and on the type of hydrocarbons considered (liquid hydrocarbons, heavy or light oil, gas, shale gas).

Where the investor is composed of several entities, the competent authority shall assess the technical and financial capacities of each of the members of the investor and decide on granting or not the petroleum rights in consideration of the financial capacities of the consortium of investors as a whole, and of the technical capacities of the operator, who will be the member of the investor that will be responsible for the day-to-day operations on the field. The law shall set that were the investor is composed of several entities; the members of the investor shall be considered joint and several to the public authority.

Where the financial and technical capacities of the investor is inferred from the financial and technical capacities of its holding companies, some guarantee mechanism need to be put in place.

The law shall also expressly set the requirement for sufficient technical and financial capacities in the context of control of (i) transfer of Authorization, or rights and obligations arising from an Authorization, to new investors and (ii) operations resulting in change of control of the investor. (see **Section 1.3.1** below)

With respect to change of operator, the requirement for approval of the competent authority shall be kept in the future model PSA.

1.1.2 Commercial entity with minimum local representation

The 2008 Petroleum Law requires that Contractor of PSA be “a limited liability corporation or entity with limited liability”²⁸ which is in line with international practices. This requirement could however be imposed on the holder of any Authorization.

24 See article 24.2 of the 2008 Petroleum Law.

25 Except indirectly through description of the powers of the SPA (see article 19.13.2 of the 2008 Petroleum Law).

26 See the absence of any such requirement in article 31.3 of the 2008 Petroleum Law.

27 See Article 21.3 of the Model PSA.

28 Article 24.2.3 of the 2008 Petroleum Law.

With respect to minimum local representation requirement, hydrocarbons legislation imposes several forms of representation, from the mere appointment of a representative locally to the incorporation of a local affiliate, through settlement of a local branch or mere registration to specific registers in order to carry business locally.

The 2008 Petroleum Law does not impose any specific local representation requirement for holder of petroleum rights and does not expressly require registers and accounts to be kept locally. Article 1.6 of the Model PSA provides that the Operator shall "*be registered to carry on business in Somalia, and shall operate under the PSA from an office located in Somalia*".

The public authority shall take into consideration the level of attractiveness of its petroleum domain while imposing such requirement. The less attractive its petroleum domain is, the less constraints oil companies will accept in this respect.

The aim of such requirement is to enable the public authority to ensure that the oil company has a local presence and the company's representatives will be more easily identifiable by the authorities and third parties. It also facilitates public authority monitoring and control of petroleum operations. The authorities can more easily proceed to inspection and audit of registers and files if those are required to be kept locally. During exploitation, this requirement also aims at facilitating public authority control of administrative formalities related to payment of taxes or customs charges.

Recommendation: Taking into account that Somalia is a frontier country in the hydrocarbons industry, the Consultant considers the level of requirement imposed in the Model PSA as adequate, both for exploration and exploitation operations. This requirement shall be set within the law.

1.2 Transparent selection process

The petroleum regime shall set the rules to secure a transparent process for selection of the investor for the granting of authorizations.

The 2008 Petroleum Law contains specific provisions for transparency of the petroleum sector. Article 43 of the 2008 Petroleum Law provides for public access to specific information and publication of reasons for the SPA for the making of certain decisions.

These transparency rules are adequate and shall be kept in the update petroleum law.

With respect to transparency in the selection process, the 2008 Petroleum Law includes the following provisions which correspond to international practices:

- (i) The responsibility to assess application for Authorization is vested in an independent authority; and
- (ii) In principle, the granting of Authorization is made through a competitive process, including public tender. Possible exceptions are provided on the basis of public interest. In each case, the independent competent authority shall publish the reasons for granting Authorization without inviting application²⁹.

²⁹ See Article 43.2 of the 2008 Petroleum Law.

Such exception makes sense in a frontier jurisdiction like Somalia where the success of a public tender process will be limited, as the attractiveness of the petroleum domain is not sufficient. All the more, such process will end up underlining the poor prospect of such area.

- (iii) Key terms of each Authorization are summarized and published in the Gazette and shall be made available to the public by the independent competent authority. Any exemption from the applicable terms of an Authorization and reason for granting such exemption shall also be made public.

The current petroleum regime could still be enhanced and complemented, as follows:

- (i) The law shall expressly indicate that the independent competent authority shall apply general principle of transparency and competitiveness for assessing applications and granting Authorizations.
- (ii) A regulation shall also be adopted to set the precise process for granting of Authorization, in order to ensure transparency.

Such regulation usually includes the required content of an application, including the various documents to demonstrate its technical and financial capacities³⁰, the name of the authority to which such application shall be filed, the various steps of the process to verify whether the application is complete and receivable, to assess the meeting of the criteria by the applicant, to negotiate the terms of the Authorization, including the terms of the PSA, as the case may be, until delivery or execution of the Authorization.

- (iii) The exception for public tender for the granting “*of Surface Access Authorization*” is acceptable. The Consultant recommends such exception be limited to Surface Authorization requested by a Contractor, for the purpose of pursuing petroleum activities in relation with petroleum operations performed in the context of its PSA.

Indeed, for instance, where a Contractor submits a development plan to exploit a field in the area of its PSA, it shall be given guarantee that it will be able to transport its production through a pipeline up to the exportation point and that it will not be subject to competition for the granting of the necessary Surface Access Authorization (see **Section 4.3.2 of Part 1** above). However, where the applicant does not hold an authorization, the independent competent authority shall be able to call for competitive offers.

Recommendation: The Consultant recommends adopting various rules within the law and the regulation, as mentioned above.

³⁰ The documents that are usually required are, with respect to financial capacities, the last annual reports of the applicant or the parent company and first demand guarantees issues by a bank or the parent company to secure performance of the minimum work program. With respect to the technical capacities, documents required usually include curriculum vitae of the company’s executives, managers and other personnel who will be in charge of the project, and description of experience of the company in similar types of project. Review of the proposed minimum work program, in a process to grant a PSA, will also allow the Government to assess the technical capacities of the applicant.

1.3 Approval and information on transfer of petroleum rights and operations affecting the investor

During the term of the petroleum rights, the public authority shall ensure that the petroleum right's holder maintains the necessary qualifications for the performance of petroleum operations. In order to do so, the petroleum regime shall allow the public authority to monitor or approve, various operations which may result in the transfer of petroleum rights or their beneficial interests or in changes in the structure or capital of the investor. In particular, petroleum regimes generally include the following requirements:

- a) Prior approval of the public authority for transfer of petroleum rights;
- b) Prior approval of the public authority for change of control of the investor;
- c) Possible termination of the Authorization, where the above requirements are not complied with;

Moreover, the petroleum regime usually provides for information with respect to other changes in the investor or in the structure of the petroleum holder to allow monitoring by the competent authority of the preservation of the relevant technical and financial capacities.

1.3.1 Prior approval of the public authority for transfer of petroleum rights

The 2008 Petroleum Law conditions effective transfer of petroleum rights to prior written approval of the SPA³¹.

In practice this implies introduction in the transfer agreement of a condition precedent for delivery of a written consent by the SPA, which corresponds to international practices. It allows the transaction to go through with execution while enabling the public authority to proceed with the approval of the operation. The law usually specifies that such approval shall not to be unreasonably withheld.

Under the 2008 Petroleum Law, the controlled operations include not only the assignment agreements, but also “*conveyance, novation, merger, encumbrance or other similar dealing in respect of an Authorization*”.

This is complemented in the Model PSA³² which specifies that approval is required in the context of similar operations by the Contractor (i) on “*all or part of its rights, interests, benefits, obligations and liabilities under it [the PSA]*”, (ii) on “*Petroleum which has not then been, but might be, recovered in the Contract Area, or any proceeds of sale of such Petroleum*” and (iii) which result in “*Petroleum or any of those rights, interests and benefits [under the PSA] [...] be held for the benefit of, or be exercisable by or for the benefit of, any other person*”. The Model PSA however excludes from control by the SPA encumbrance granted by the Contractor, which is not a secured borrowing although it has an economic or financial effect similar to that of a secured borrowing. This exception appears as a contradiction to the 2008 Petroleum Law.

The prior approval required under the 2008 Petroleum Law only aims at approving effective transfer, leaving aside agreements, such as memorandum of understanding containing promise

31 See Article 31.3 of the 2008 Petroleum Law.

32 See Article 21.1 of the Model PSA.

of transfer. This approach is sensible where it is required to include a condition precedent for entry into force of the transfer.

Finally, none of the 2008 Petroleum Law or the Model PSA sets a preemptive right of Somalia to acquire any assigned rights and obligations.

Recommendation: The Consultant recommends keeping a condition precedent with respect to the listed transfer operations for approval of the competent authority. The precision that transfer operations to be controlled by the competent authority includes operations on all or part of the rights, interest, benefits, obligations or liability shall be included in the updated law, instead of being kept in the PSA. The other precisions (under Article 21.1 (b) (ii) and (iii) of the Model PSA) does not need to be reset in the law, as any such transactions would be included in the above referred to operations (as under 21.1 (b) (i) of the Model PSA).

With respect to encumbrance, the regime needs to be clarified. In any case the actual transfer of the specific rights and obligations as a result of implementation of such encumbrance shall be subject to prior approval of the competent authority. In this context, the competent authority may allow the Contractor to grant an encumbrance on petroleum rights, in all or part, without the prior approval of the competent authority (but with prior information), as long as such encumbrance (i) is granted to secure financing of specific petroleum operations to be performed in relation to such petroleum rights, and (ii) does not affect any other rights and obligations of the Contractor. The granting of any other encumbrance shall be subject to the prior approval of the competent authority.

The regulation shall specify the period for the competent authority to grant its written consent. Such approval shall be a positive act of the competent authority.

Agreements preliminary to transfer (such as memorandum of understanding, or encumbrance) shall be subject to notification by the holder of the petroleum right to the competent authority .

The regulation or the Authorization shall refer to specific documents or information to be provided by the transferee and the transferor for the competent authority to assess the technical and financial capacities of the transferee and be assured of the pursuit of petroleum operations.

The required documents shall include, with respect to the transfer of exploration rights, a guarantee in the same form as earlier provided by the transferor to secure performance of the minimum work program. In any case, the transferee shall commit within the transfer agreement to pursue petroleum operations, including minimum work and expenditures if the transfer occurs during the exploration phase, or development plan or production plan if the transfer occurs during the exploitation phase. Finally, the regulation shall impose transmission of the transfer agreement, which shall include the condition precedent with respect to the prior approval of the competent authority.

The regulation shall also require details on the transaction, especially in the light of (i) potential exercise by Somalia of its preemptive right and (ii) taxation of the transaction.

(i) *Preemptive right of the public authority*

The Consultant recommends setting such a right as a possibility in the law, with the principle that such right shall be exercisable within a limited period of time from submission of the proposed transaction for approval of the competent authority, and at similar conditions (particularly as regard prices and terms of

payment) to the conditions that were agreed between the proposed assignee and the transferor. The detailed conditions for exercise of such right shall be set in the Authorization or regulation. The NOC shall be the beneficiary of such right.

(ii) Taxation of the transaction

Assignment of petroleum rights are often made at a much higher price than the amount of petroleum costs incurred and not recovered by the transferor. The price indeed usually includes anticipation on the benefits to come from the petroleum rights, especially where a commercial discovery has been made. In this context it is common that the public authority taxes the transferor for the benefits gained from such transaction. See **Section 12.1 of Part 4** below for recommendations on such taxation. However, as will be discussed in **Part 4**, it is important to distinguish assignments aimed at involving new partners to share the project's financing and enhance overall execution. Such assignments have different pricing structure and should not be targeted by the capital gains taxation.

1.3.2 Prior approval of the public authority for change of control of the investor

The 2008 Petroleum Law provides for prior approval of the SPA in the context of change of control of an authorized person; however it limits control of the SPA to the sole direct changes of control³³.

The technical and financial capacities of the investor may also be affected where it is subject to a change of control, either direct or indirect. Therefore, prior approval of the SPA shall be required for indirect change of control as well. Such control shall however be limited to operations where the country has sufficient legitimacy to approve such change of control. This would be the case where the petroleum assets in Somalia represent the main assets of the concerned company.

Recommendation: The Consultant recommends adding provisions in the petroleum law to allow control of indirect change of control, where the transaction concerns a company which assets are mainly composed of petroleum rights in Somalia. The regulation shall set a precise definition of what is a company which assets are mainly composed of petroleum rights in Somalia.

Other indirect change of control shall be subject to prior notification to the competent authority which shall be able to require further information and guarantee, as the case may be.

1.3.3 Termination of the Authorization where the above requirements are not complied with

The 2008 Petroleum Law expressly specifies that the SPA may terminate the Authorization only with respect to approval for change of control, not with respect to transfer of petroleum rights.

Recommendation: The Consultant recommends that the law expressly specifies the possibility for the competent authority to withdraw the Authorization where a transaction is implemented without the prior written consent of the competent authority, including with respect to transfer of petroleum rights.

³³ See Article 31.2 of the 2008 Petroleum Law and the definition of "Control" under Article 1 of the 2008 Petroleum Law.

1.3.4 Other information requirements

The 2008 Petroleum Law provides for prior approval of the SPA with respect to entry into a Joint Operating Agreement (JOA) or a lifting agreement and any amendment to any such agreements. It is specified that the SPA must approve such agreement or amendment where they are compliant with the Authorization.

This requirement for prior approval, especially with respect to amendments, appears too stringent on the investor. Most of the changes that may arise from such amendment will not affect the technical and financial capacities of the investor. The main change which is usually subject to prior approval of the public authority is the change of operator. The Model PSA provides for prior approval of the SPA in this respect³⁴.

Other amendments may be significant but shall not require the approval of the public authority, in its role of regulator of the petroleum sector, but merely the consent of the NOC, as member of the Contractor, and party to the JOA or the lifting agreement.

Finally, the 2008 Petroleum Law lacks provision for a general obligation for the authorized person to notify the competent authority any change affecting him. The competent authority shall be provided with any information relative to change in the investor from the presentation made by such investor upon application. This would include information relative to change of directors, change of head office, change in the articles of association of the company, or change in the capital of the investor, either direct or indirect. Where such change does not correspond to a change of control, it shall only require notification to the competent authority, for monitoring purposes.

Recommendations: The Consultant recommends deleting the requirement for prior approval of the competent authority with respect to entry into a JOA or a lifting agreement. It shall indeed be kept in mind that the NOC will be part of the JOA were a participation is taken by the public authority and that the members of the investor will be considered joint and several to the public authority. The competent authority shall nevertheless be communicated any signed JOA or lifting agreement and its approval shall be required for any significant change to such agreement, in particular to the change in operatorship.

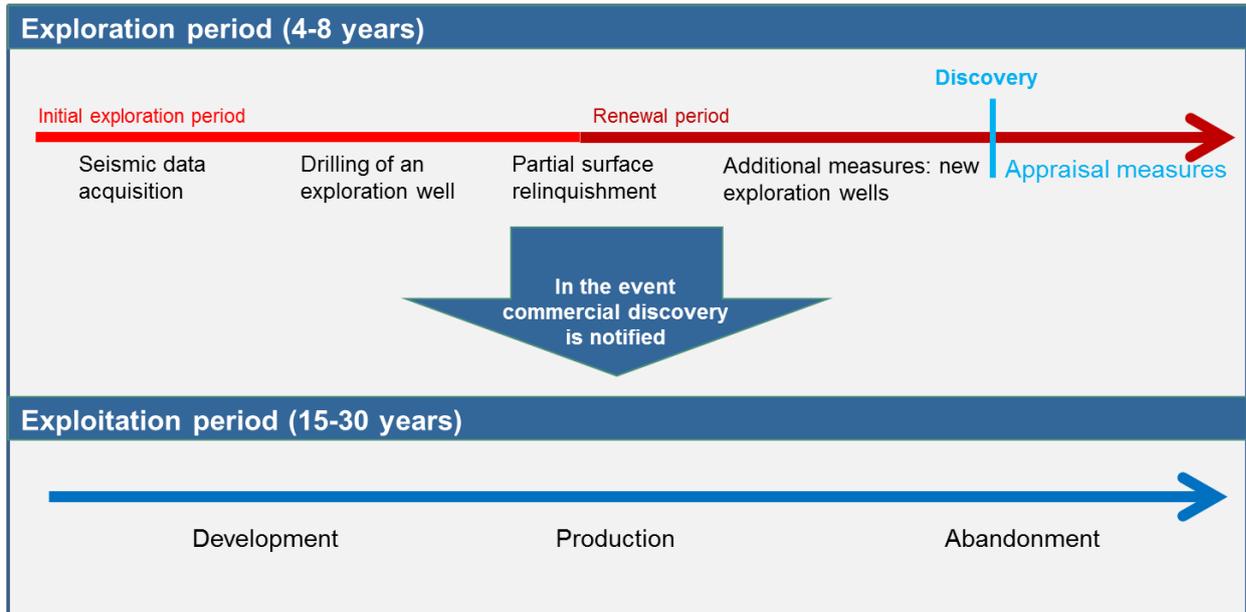
Finally, the Consultant recommends inserting a general obligation for the investor to notify the competent authority with information regarding any change in the investor. Moreover, the law shall impose communication to the competent authority of each annual report of the investor (and consolidated annual report of its mother company). The public authority shall then be able to exercise its general right of control on the petroleum operations with respect to the quality of the investor, in particular by assessing on a regular basis its technical and financial capacities.

2. CONTROL ON EXPLORATION AND PRODUCTION OPERATIONS

One of the public authority's main concerns with respect to petroleum operation is to ensure that the investor is performing such operations in a timely and professional manner. The below

³⁴ See Articles 1.6 (e) and 21.4 of the Model PSA.

scheme represents the various usual steps of an exploration and production hydrocarbons project:



The petroleum regime shall, considering the various usual milestones in a hydrocarbon project, set rules for (i) prompt exploration, (ii) prompt appraisal and decision on the opportunity to develop a discovery and (iii) continuous and optimal exploitation, and more generally (iv) the monitoring of petroleum operations by the public authority.

2.1 Prompt exploration

The public authority aims at obtaining prompt information on the content of the subsoil. To this end, the public authority needs to organize a coherent management of the national petroleum domain (2.1.1). Moreover, the PSA is granting exclusive right to perform Petroleum Operations in the contract area. This right has to be subject to minimum work requirements (2.1.2) and limited timeframe to ensure prompt exploration (2.1.3).

2.1.1 Coherent management of the national petroleum domain

Coherent management of the petroleum domain implies (i) graticulation of the domain, and establishment of a unique register to help the authorities to have a consistent and exhaustive view of the national petroleum domain. The coherence of the management is then ensured thanks to (ii) the designation of a single entity responsible for the management of such domain and the granting of authorizations.

2.1.1.1 Graticulation and register

The 2008 Petroleum Law provides for “*the graticulation of the Territory of Somalia*”, which shall mean the entire Federal Republic territory, “*according to a grid system which conforms to accepted international standards and norms of graticulation*”³⁵.

35 See article 22 of the 2008 Petroleum Law.

It does not mention the existence of a national register with respect to the petroleum domain.

The graticulation of the Somali territory has been performed, in accordance with the standard and norms consisting on division into squares with north-south and east-west lines delimitation. A map of the graticulated territory of Somalia is available on the website of the Somali minister of petroleum and mineral resources and dates back from January 2015 (**Schedule 3**). This graticulation is purely standard and does not include any specificity related to the division in regions of the territory.

Recommendation: In the specific federal context of Somalia and to avoid further difficulties with the regions, the Consultant recommends that as soon as the boundaries of the territory of the various regions are set, the graticulation takes into account the delimitation of the regions. Authorizations to be granted shall correspond to the blocks delimited through this graticulation.

Nevertheless, Somalia shall anticipate that there may be circumstances field lies on several Member States' territory. In this case, certain issues such as allocation of revenue between the Member States will need to be solved. The respective Contractors of the concerned PSAs will negotiate a unitization agreement for common development and exploitation of the discovery. In parallel, the concerned Member States and the Federal Government may negotiate an agreement to solve these issues.

The petroleum law shall also set the authority competent for deciding on the graticulation.

The Consultant also recommends that a register be established to gather information regarding all the blocks of the FGS or of the Member State depending on the level at which management of the petroleum sector is set. The register usually receives written mentions of any application for petroleum rights on a block (which notably guarantees the investors a fair treatment of their application in accordance with the priority rules), of any granted Authorization, and of any change, transfer or encumbrance relative to such Authorization and in some cases to the related investor.

2.1.1.2 One single authority for the management of the petroleum domain

The 2008 Petroleum Law does not expressly designate the authority responsible for the management of the petroleum domain.

This authority is usually also responsible for the establishment and keeping of the register and granting of authorizations.

One of the concerns of the authority shall be to maintain diversity in the investors present on the domain, to avoid one specific actor to have a preeminent position on the domain. Most petroleum regime impose a maximum surface to be granted to one specific investor, both as a single exploration area, or as a maximum number of authorization that an investor may be granted.

The 2008 Petroleum Law set a maximum of 5.000 sq. km per PSA but it does not set a maximum number of PSA one single investor may enter into.

Recommendation: The Consultant recommends that the competent authority responsible for the management of the petroleum domain be designated as responsible for keeping of the register.

2.1.2 Minimum work requirements

Minimum work requirements are set through (i) a time period for the investor to start exploration works and (ii) the commitment from the investor to implement a minimum work program.

2.1.2.1 Maximum period to start exploration works

None of the 2008 Petroleum Law or the Model PSA sets a period within which the Contractor shall start exploration works. Petroleum laws usually impose the petroleum exploration right holder to start exploration works within a maximum period of six (6) months to one (1) year.

Recommendation: The Consultant recommends inserting such an obligation within the law, with respect to the PSA, along with a possibility for the competent authority to terminate the PSA, where exploration works did not start within a period of one year for no legitimate reason. This potential termination shall not prevent the authorities from imposing penalties for delay in performing the work.

2.1.2.2 Contractual commitment to a minimum work program and the related financial security

The 2008 Petroleum Law refers to minimum work programs as a mandatory provision of the PSA³⁶, meaning that the minimum work programs for the various exploration periods are set in the PSA at its entry into force, which correspond to international practices.

However, the Model PSA is not in line with international practices with respect to the minimum work requirement.

It indeed sets a commitment to incur minimum expenditures expressed with an amount, instead of a commitment to perform specific minimum works. Additionally, Articles 4.1, 4.2 and 4.3 specify that the “*Contractor shall carry out an Exploration Work Program and Budget involving an expenditure of not less than the amount specified*”. This tends to draw confusion between the minimum exploration work program, which is set upon execution of the PSA, and the annual exploration work program and budget, which is approved annually.

Finally, the Model PSA does not impose the usual sanction on the Contractor where such program is not performed. Although the Model PSA complies with the international practices, providing for payment of liquidated damages and guaranteeing such payment thanks to the provision of a financial security, such payment of liquidated damages is set as a mere option, at the discretion of the Federal Government, the other option being to “*require that the shortfall be added to the Exploration Work Program and Budget to be carried out in the next Contract Year*”³⁷. Moreover, the exploration period may still be renewed and therefore the PSA will not terminate as under international practices (see **Section 2.1.3.2** below).

Recommendation: The Consultant recommends amending the Model PSA to make it compliant with Article 24.6.1 of the 2008 Petroleum Law which is in line with international practices. In this respect, Article 4 of the Model PSA shall set minimum work commitment instead of minimum expenditure commitment, and with respect to each exploration period instead of each contract year.

³⁶ See Article 24.6.1 of the 2008 Petroleum Law.

³⁷ See Article 4.5 (a) of the Model PSA.

The minimum work programs shall specify the minimum work to be performed during the concerned exploration period. The Contractor shall be considered having performed the minimum work program where it has acquired/interpreted such number of km or drilled such number of wells, whether or not it incurred or exceeded the estimated minimum expenditures. The amount of expenditures specified with respect to such program shall be indicative and shall only aim at determining in advance the amount of liquidated damages to be paid by the Contractor where it fails to perform the listed work.

The Consultant recommends with respect to sanction for non-performance of minimum work commitment to link renewal of the exploration period to the performance of the minimum work program (see **Section 2.1.3.2** below).

Apart from the above, the Consultant considers that the Model PSA is compliant with international practices with respect to the amount of liquidated damages to be paid which are “of the estimated costs of the Exploration works not carried out”³⁸ and with respect to the financial security to be provided by the Contractor, as a condition precedent to entry into force of the PSA.

It should be noted that the cost of such financial security for the Contractor could be diminished by allowing reduction, each year, of the amount of such security pro rata to the progress of the works.

2.1.3 Limitation in time

Limitation in time is set through (i) maximum duration of the exploration rights, and limited (ii) renewal or (iii) extension of such rights.

2.1.3.1 Maximum duration of the exploration period

The Model PSA sets a regulatory maximum duration of the exploration phase of seven years which is in line with the average maximum duration of exploration phase in peer countries. Such phase is fractioned into three different periods (of 3, 2 and 2 years), as it is usually the case under best international practices.

Where the model PSA would be set at the regulatory level, as recommended, the public authority negotiating the PSA will not be bind by such maximum duration of the exploration period. The actual maximum duration of the exploration period is indeed set as a result of the negotiation with the investor, in consideration of the specific circumstances of the contract area.

Recommendation: In order to maintain a limit in the discretionary power of the public authority in the negotiation of such duration, the Consultant recommends that the overall maximum duration of the exploration phase be set in the petroleum law. The seven year maximum duration, as set in the Model PSA, shall be set in the petroleum law.

2.1.3.2 Limited renewal of the exploration period

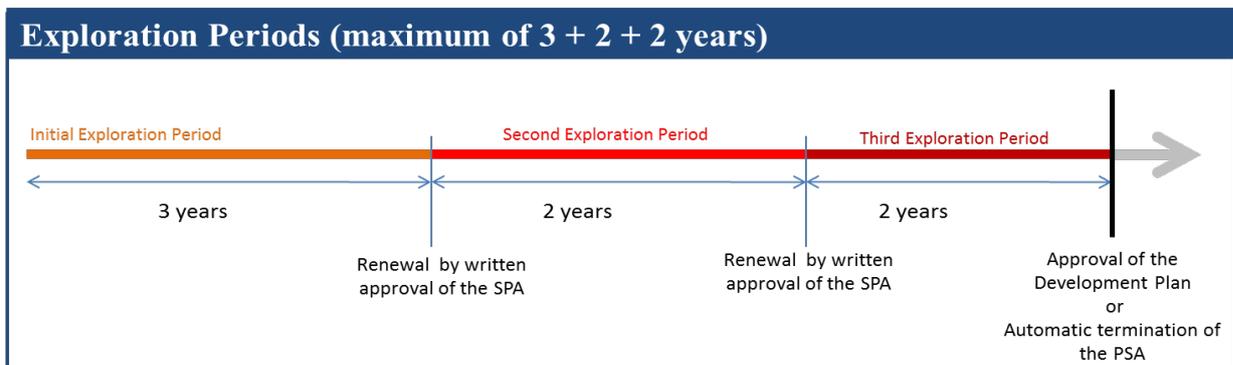
Contrary to international practices, the Model PSA does not provide for renewal of the exploration period, but for automatic pursuit of the exploration period up to the end of the seven

38 See Article 4.5 (a) (i) of the Model PSA.

year period³⁹. In this context, the renewal of the exploration period is not subject to the usual specific conditions set under petroleum regimes which are (i) performance of the minimum work program and (ii) relinquishment of part of the contract area.

The Model PSA only requests relinquishment of part of the contract area. Where the Contractor does not relinquish part of the contract area as requested at the end of each exploration period, the total contract area is deemed relinquished and the PSA terminates. This provision does not put the same constraint on the Contractor with respect to carrying out of the minimum work program. The regime is not as protective for the public authority as usually set under international practices.

Recommendation: The Consultant recommends that the petroleum law sets the principles for duration and renewal of the exploration period of the PSA as it is usually found in petroleum regimes: the petroleum law shall set the maximum duration of the first exploration period, the principle that such period is renewable for a specified maximum duration and for a specified number of occasions. The specific parameters set under the Model PSA (total duration of seven years, the first period being three years maximum, renewable, upon request and approval of the relevant authority, twice for two years each time) are within the best practices and could be used as specific parameters for Somalia to be set within the petroleum law. It shall be underlined that such specific parameters are maximums. The various exploration periods may then be shorter, depending on specific circumstances.



The law shall specify that the Contractor is entitled to such renewal where it has (i) performed the minimum work program of the current exploration period and (ii) relinquished part of the contract area as required.

The relevant authority shall not be able to unreasonably withhold its approval.

2.1.3.3 Exceptional extension of the exploration period

The Model PSA provides for extension in the following circumstances:

- for drilling of a substitute well where a first well could not reach its objectives for reasons others than listed specific reasons, for “*the time spent in preparing for and drilling the substitute well, including mobilization and demobilization of drilling rig*”⁴⁰. Such extension is automatic. No express approval is required.

³⁹ See Article 3.1 (d) of the Model PSA.

⁴⁰ See Article 4.4 of the Model PSA.

- where a discovery has been made and the Contractor needs more time to appraise it, “for such period as is reasonably necessary to permit the Contractor to Appraise [...] the Discovery”, and only “for such area [...] reasonably necessary for Appraisal of the Discovery”⁴¹. Such extension is automatic. No express approval is required.
- for retention of the right over a discovery of non-associated gas which appraisal demonstrates that such discovery is not commercially viable yet “but is likely to become so within a period of five years”⁴². This extension, which is subject to approval of the Federal Government, shall last “as long as [...] the Contractor diligently seeks to make it (the discovery) commercially viable, and demonstrate to the [Federal] Government that it is doing so”⁴³ up to a maximum period of five years.

Recommendations: The Consultant recommends setting within the petroleum law the principle that regulations may provide for specific exceptional cases of extension of the exploration period.

The regulation shall set the limited cases of extension and their maximum duration. As far as possible, the regulation shall not only refer, as under the Model PSA, to “such period as is reasonably necessary” for performance of the specified work but to a maximum duration set in number of months, or years, as the case may be.

With respect to cases listed under the Model PSA, the Consultant recommends (i) deleting the case relative to the substitute well, which is not international practices, and (ii) adding the following case for extension of either exploration period: for completion of a drilling program the Contractor has started but has not completed, for the period reasonably necessary for completion of such program, including analysis of the drilling results to determine whether there is a discovery or not, up to a maximum period to be set [six months].

Such extension shall be subject to express approval of the competent authority, upon request of the Contractor. The regulation shall set the rules (procedure, content of the request...) for such approval. Such approval shall in any case set the maximum duration of such extension, in number of months or years, in consideration of the proposed work program to be submitted by the Contractor together with the request for extension.

2.2 Prompt appraisal and decision of development of a discovery

Once a discovery is made, it is appraised to determine whether it is commercially viable and whether it shall be developed. The public authority needs to make sure that the various steps in this process are carried out in a limited period of time. In international practices, all these operations are part of the exploration works and the starting point of the exploitation period is the express positive act from the relevant authority authorizing performance of the development plan with respect to the discovery.

The petroleum regimes also set specific rules with respect to appraisal of a gas discovery.

41 See Article 3.2 (b) of the Model PSA.

42 See Article 3.5 of the Model PSA.

43 See Article 3.5 of the Model PSA.

2.2.1 Various milestones from discovery to submission of the development plan

The 2008 Petroleum Law and the Model PSA do not set rules which enable Somalia to be sure that the discovery will be promptly appraised and that the investor will take a decision to develop or not such discovery within a limited period of time.

The 2008 Petroleum Law only provides for notification of the discovery within a period of 24 hours from discovery⁴⁴. The Model PSA only requires (i) submission of an appraisal program “at such time and in such manner as the [Federal] Government requires”⁴⁵, and (ii) that the “Contractor submit, for approval of the [Federal] Government, a Development Plan for the Development Area” in “not more than twelve (12) months after the declaration of a Development Area”⁴⁶. The Somali petroleum regime does not set milestones between these two dates, nor any time limit for the Contractor to notify its declaration of commerciality. Moreover the above mentioned 12 months period starts from a date arising in an undefined time period after the date of the declaration of commerciality and appears much longer than the average period in the international oil industry.

Recommendation: The Consultant recommends that the petroleum regime sets maximum periods for the Contractor to achieve the various steps up to declaration of commerciality and submission of a development plan for approval, pursuant to the procedure discussed in the Recommendations set under **Section 2.2.2** below. Such provision may be in the petroleum law or in the regulation, as listed in the table below.

44 See Article 24.4.1 of the 2008 Petroleum Law.

45 See Article 4.9 (c) of the Model PSA.

46 See Article 4.11 (a) of the Model PSA.

Various steps in international best practices	Recommendations for enhancing the current regime
Notification of the discovery by the Contractor	This step is already provided for in the law.
Submission of a report on the discovery to the competent authority and notification to the competent authority of the decision to appraise the discovery or not	The regulation shall provide for submission by the Contractor of a limited report on the discovery within a relatively short period of time [one month from discovery]. The Contractor shall declare whether it intends to appraise such discovery in approximately the same period of time. Where the Contractor intends to conduct appraisal, it shall declare a discovery area.
Submission by the Contractor of its appraisal program and budget for approval	The regulation shall impose submission of the appraisal program and budget within a maximum period [3 months] from the notification of the discovery, not only "at such time and in such manner as the Government requires" (section 4.9 (c) of the Model PSA) .
Maximum period to start appraisal works as set in the approved appraisal program	The regulation shall impose starting of appraisal works at the latest [3 months] from approval of the appraisal program.
Submission of the report following appraisal	The regulation shall impose the Contractor to submit the report on the results of the appraisal works within a period of [2 months] from completion of the appraisal program. The regulation shall also set the expected content of such report.
Declaration of commerciality	The law shall limit to [one (1) month] from the submission of the appraisal report and [3 months] from completion of the appraisal program, the period for the Contractor to declare the commerciality of the discovery. The law may also set a maximum period from the notification of the discovery to declare such commerciality.
Submission of the Development Plan	The Contractor shall have a maximum period of [2 months] from the declaration of commerciality of the discovery to submit a development plan for approval, in order to move to the exploitation period.

The length of such periods shall be assessed by Somalia. It may vary depending on the distances involved in relation to the exploration or processing zones. A landlocked country or a new comer in the oil industry for example, will want to increase the evaluation period or allow a longer period for notice of commercial viability of a discovery, so as to enable the Contractor to resolve matters of hydrocarbon transport and export.

The law or the regulation may not include maximum period for each of the listed steps. Most importantly, the petroleum regime shall impose a limit period for declaration of commerciality and from declaration of commerciality for decision to develop and submission of a development plan. Where the Contractor does not comply with one of these deadlines, except for legitimate reasons, the Contractor shall be deemed to renounce to the discovery and the PSA may be terminated with respect to the discovery area. The public authority shall have the right to evaluate or order an evaluation of the discovery and subsequently to develop it for its own account.

Please note that the appraisal program shall be approved by the competent authority within a limited period of time and that such approval shall not be unreasonably withheld. Such program shall not be limited to a contract year; it shall be a program for the entire duration of the works necessary for proper appraisal of the discovery. Such approval is usually made using the same process as the annual work program.

2.2.2 Development Area, exploitation period and approval of the development plan

The moment at which the exploration period terminates and the Contractor enters the exploitation period in the current Somali petroleum regime is not in line with international practices.

Under the Model PSA, the exploration period ends, with respect to the development area, at the time the Federal Government declares the development area⁴⁷.

Such declaration is made by the Federal Government following proposal by the Contractor of a development area, upon declaration of commerciality of a discovery. The Model PSA does not set any limit in time for declaration of the development area. Moreover, the Contractor has a period of 12 months to submit a development plan for approval of the Federal Government. Finally, the Consultant notes that approval of the development plan does not require an express decision of the Federal Government and can result of the silence of the Federal Government.

This approach is rather unorthodox in the international oil industry. The entry into the exploitation period usually corresponds to the date at which the development plan is formally approved; approval of the development being a significant milestone in a petroleum project, and requiring the express decision of the relevant authority.

The Consultant notes that the provisions, under the Model PSA relative to determination of the development area, and, under the 2008 Petroleum Law relative to unitization, are in line with international practices.

Recommendations: The Consultant recommends inserting in the petroleum law the following principles: (i) a PSA contains two phases, the exploration phase and the exploitation phase; (ii) the exploitation phase starts, with respect to the development area, at the date of approval of the development plan; and (iii) such approval shall be formal approval by the relevant authority, not mere non opposition to the proposed plan.

Apart from the formal approval by the relevant authority, the Consultant considers the proposed process for approval of the development plan as mostly adequate:

- The required content of the development plan in Article 4.11 of the Model PSA does not appeal any specific remark from the Consultant, as it corresponds to the usual required content;
- The concertation between the public authority and the Contractor to adjust the development plan is appropriate;
- The 30 day period for the Contractor shall probably be raised up to 60 days, at least.

Nevertheless, as the development plan shall be approved through a positive act of the relevant authority, the regulation shall sets rules for resolution of disputes that may arise in the process for approval of the development plan. The relevant authority shall not withhold its consent except for legitimate reasons. The investor will consider this kind of provision before applying for petroleum rights. It is indeed essential for the investor to be able to convert a discovery into production, where it considers it is commercially viable. The Consultant recommends inserting a possible recourse to a third party technical expert which decision will be binding on the parties,

⁴⁷ See Articles 4.10 and 3.3 of the Model PSA.

where no agreement is reached on the development plan within a certain period of time, following comments by the competent authority on such plan. This can be set at the regulatory level.

2.2.3 Specific rules relative to gas

In line with best practices in emerging countries such as Somalia, the Model PSA provides for a possible additional period to be granted to the Contractor to enable it to further assess the commercial viability of a gas discovery, through the concept of the Gas Retention Area⁴⁸ (see **Section 2.1.3.3** above). This possibility is offered with respect to gas in particular as in most African jurisdictions the gas market is not locally developed. Therefore valorization of such production requires installation of specific and significant infrastructures, such as pipelines or LNG transformation, for evacuation and sale on a foreign market.

This exceptional possibility may be widened to other types of discovery (marginal fields for instance), in the current context of Somalia, where no oil infrastructures are yet set.

The Somalia current petroleum regime however does not set any provisions with respect to associated gas, meaning gas that is contained within a crude oil deposit and which will be extracted together with crude oil. The commercial viability of the discovery is not assessed in consideration of gas, but in consideration of crude oil. Where such discovery of oil is declared commercially viable, the Contractor shall be imposed to manage gas that will be extracted together with oil.

Recommendation: The Consultant recommends setting in the petroleum law, a principle, similar to the principle allowing a Gas Retention Area in the Model PSA, that a retention area may be granted to the Contractor with respect to discoveries which appraisal demonstrates that such discovery is not commercially viable yet, but is likely to become so within a period of time to be determined. The law may also mention gas discovery as one of the circumstances which may allow such additional period. The regulation may then further specify the type of discovery to which this option may apply.

With respect to associated gas, the law shall specify that any development plan shall include proposal for the valorization of hydrocarbons contained in the discovered deposit, including as the case may be associated gas. With respect to associated gas, where valorization is not envisaged by the Contractor, such plan shall present the measures to be implemented for management of such gas, in particular to avoid flaring and favor reinjection into the deposit. It shall also be expressly stated within the law that there shall be no gas flaring except under authorization and for safety reasons. The law shall also set applicable penalties to be paid for flaring gas without authorization.

The public authority shall have the option, where the Contractor renounces to develop associated gas, to require from the Contractor that it makes such associated gas available to the public authority at a defined point, it being specified that the cost for construction and operation of installations to make gas available to the public authority shall be considered as recoverable costs.

⁴⁸ See Article 3.5 of the Model PSA.

2.3 Continuous and optimal exploitation

The public authority is concerned during the exploitation period that it will receive stable revenue, as soon as possible. In this respect, it wishes that extraction and commercial returns start as soon as possible and that operations be conducted in such a way to ensure continuous and optimal exploitation.

2.3.1 Prompt development and commercial production

In general the Somali petroleum regime does not set provisions to ensure prompt development and commercial production.

The Somali petroleum regime does not set provision to limit the time period before which development works shall start and be achieved, nor before which the commercial production date shall occur.

The duration of the exploitation period is set in relation to a development area in the Model PSA. It starts from the date of commercial production.

Recommendation: The Consultant recommends setting the maximum duration of the exploitation period not only within the model PSA but also within the law, to give a legal frame to the negotiations of the PSA on this point. Contrary to what is set in the Model PSA, the exploitation period shall be defined from the date of approval of the development plan, to force the Contractor to perform development works in a timely manner, start exploitation operations and reach commercial production date as soon as possible.

In accordance with most petroleum regimes, the Contractor shall be entitled to the renewal of its exploitation rights where it can justify that it performed its obligations under the PSA and that such reservoir contains sufficient remaining commercial reserves. The renewal period is usually a limited period [5 to 10 years] up to the exhaustion of the reservoir. The law may also specify that such renewal may be subject to execution of an amendment to the PSA with respect to specific provisions, in particular production sharing provisions.

The law shall also set the principle that development works shall start within a limited period of time from approval of the development plan [maximum six months] and that the date of commercial production shall be reached by the time period set within the development plan. Failure to start development works or achieve commercial production before such dates for no legitimate reason shall be considered as a material breach of the PSA justifying termination.

The definition of commercial production date shall be set within the PSA. Such definition shall be precise as this date will trigger payment of various taxes, either from the date of commercial production, or from the year during which or following the date of commercial production. The Consultant recommends that the definition refer to a level of production to be set within the development plan.

2.3.2 Continuous and optimal exploitation

The Model PSA provides for the relinquishment of the development area where production would be “*ceasing permanently or for a continuous period of twelve (12) months*”⁴⁹. Such

⁴⁹ See Article 3.3 (a) (i) of the Model PSA.

provision is compliant with international practices. The Consultant recommends setting such provision within the law, instead of the Model PSA.

The Model PSA also requires that the Development plan contains “*the production profile, including [...] the specific rates of Petroleum production*”⁵⁰. The Model PSA also requires annual approval of the Development Work Program and Budget and makes it clear that such program shall be in line with the Development plan⁵¹.

These provisions are in line with international practices.

Recommendation: The Consultant recommends adding provisions specifying the annual Development Work Program and Budget shall contain annual, as well as five-year, estimate of production, revenue and costs (CAPEX and OPEX). The Contractor shall also submit regular report on its activities and production. Most regulations impose a monthly report and an annual report.

2.4 General monitoring of petroleum operations by the public authority

The general monitoring of petroleum operations is performed by the public authority through the prior approval of the annual work program, the committee put in place in the context of each PSA and the review of the information to be provided by the Contractor. It also implies the exercise of a power of control and sanction, as may be required, by the relevant authority, to impose proper performance of operations on the basis of the applicable standard of care.

2.4.1 Annual Work Programs and Budgets

The Model PSA sets the rules for submission, review and approval of the annual work programs and budgets by the relevant authority, as usually stated under petroleum regimes. The power to approve the annual work programs and budgets is vested in the Federal Government, meaning as soon as operational, the SPA. The annual work programs and budgets may be revised during the corresponding year subject to the SPA’s approval.

The SPA will check that such annual work program and budget are compliant with the Contractor’s commitment under the minimum work program during exploration and under the development plan and the production plan during exploitation.

The Model PSA states that failure by the Federal Government to raise comments on the submitted work programs and budgets, within the limited period of time (30 or 15 Days), shall be deemed approval where such program complies with either the minimum work program (in activity and expenditure) for the same contract year during exploration, or the development and production programs during development or production phases.

⁵⁰ See Article 4.11 (d) (iii) of the Model PSA.

⁵¹ See Article 4.12 of the Model PSA.

The cost incurred in compliance with the approved work program and budget will be considered as recoverable costs in a PSA. In this respect, the relevant authority will also assess whether the proposed works and related expenditures are adequate and reasonable in consideration of the purpose to be achieved. In this context, the Model PSA also sets rules limiting the possibility for the Contractor to incur expenditures exceeding the approved annual budget. These provisions are in line with international practices. However the Model PSA does not specify the sanction where expenditures are incurred which exceed the approved annual budget.

Recommendations: The Consultant recommends that annual work program and budget be approved within the Management Committee. The competent authority shall be represented in the Management Committee. Rules for examination and approval of such programs and budget within the Management Committee will need to be set.

The Consultant also recommends specifying that where over expenditures are incurred, which are exceeding acceptable emergency over expenditures or which are not retroactively approved by the public authority, as set under the Model PSA, such expenditures shall be not be treated as recoverable.

Finally, the provision of Article 4.7 (e) of the Model PSA shall be deleted as it reveals confusion between the annual work program and budget and the minimum work program during the exploration phase.

2.4.2 Management committee

The Model PSA provides for the management of operations within a Management Committee to be established with an equal number of representatives from the Federal Government, one of whom being the chairman, and from the Contractor. Article 16 of the PSA provides for minimum number of meetings to be held within the year and matters to be examined within such committee. These provisions are usual minimum provisions with respect to such committee.

The exact role of the Management Committee is however not clear, notably with respect to the annual work programs and budgets, and should be clarified. The decision process within the Management Committee is not set either.

Recommendations: The Consultant recommends setting more clearly the role of the Management Committee and vesting such committee with decision making powers on certain matters, notably on the annual work programs and budgets (see **Section 2.4.1** above). The role of a Management Committee is usually to examine and decide on the main orientations of the petroleum operations, programs and budget, and to monitor execution of such programs.

In any case, the Consultant recommends that the decision making process be specified within the Model PSA. Such process shall in particular determine the quorum, the majority and the final decision process where there would be a dispute. The majority rules and final decision process vary depending on the type of decision submitted to such committee. A limited list of decisions shall be submitted for decision of the Management Committee with a positive vote of representatives of the public authority. Depending on the concerned stage of petroleum operations, the representative of the public authority will be able to comment, propose changes, approve, reject or impose changes on program proposed by the Contractor.

2.4.3 Regular information review

Apart from provisions for transfer by the Contractor to the Federal Government of all data and information acquired as a result of carrying out petroleum operations, including analysis of such data, the Somali petroleum regime does not expressly set requirements for the provision by the Contractor of regular reports on petroleum activities.

In international practices, such requirement is set at the regulatory level. It includes provision of reports on a regular basis (annual report for all kind of operations, quarterly for exploration works, monthly on production and daily where a drilling operation is conducted). It also imposes to the Contractor specific information in relation with specific operations such as: notification for conduct of drilling or seismic acquisitions, provision of report on seismic or drilling operations or on a discovery.

With respect to environment, health and safety issue, the authorization holder shall be under the obligation to notify any incident which arises and to elaborate a report on such incident afterwards to present the measures taken to remedy such incident, as well as the reasons for such incident and the measures taken, and to be taken, to avoid any new incident of the same kind.

Recommendation: The Consultant recommends inserting such requirements in the regulation to allow public authority to have information on the actual performance of petroleum operations.

2.4.4 Standard of care and power of control of the public authority

The 2008 Petroleum Law sets the main principles for the control by Somalia (through the SPA) that the petroleum operations are conducted pursuant to the following standard of care. These matters are well treated within the current Somali petroleum regime and only require limited modifications, as follows:

- It sets the Good Oil Field Practice as the applicable standard of care for the conduct of petroleum operations in Somalia.

The Good Oil Field Practice is defined under article 36 of the 2008 Petroleum Law as "*the practices employed in the petroleum industry worldwide by prudent and diligent operators under conditions and circumstances similar*". The Model PSA also uses the same notion and corresponding definition. Such standard of care is compliant with the international oil practices.

- It vests the SPA with power to inspect operations on site, to investigate on requirement or condition of an Authorization, or to be provided with specific documentation for investigation, including financial audit. The inspected person is under the obligation to cooperate.
- It vests the SPA with the power to "*order and require any person to do [...] any act [...] required to do under this Law, the Regulation or any Authorization or rule, any decision, order or direction [...] and forbid the doing or continuing of any act [...] that is contrary to this Law, the Regulation or any such Authorization, rule decision, order or direction*"⁵².

52 See article 19.14.8 of the 2008 Petroleum Law.

The Consultant recommends that this provision be amended to allow the competent authority to order in such a way to compliance with the Good Oil Field Practice as well.

- It vests the SPA with the power to sanction wrongful behavior in breach of Authorization, order or decision and to “*assess penalties*”⁵³ in this respect. Penalties are set under Chapter VIII of the 2008 Petroleum Law. The SPA may also modify or revoke Authorization as permitted under the law, regulation or concerned Authorization.

The cases for revocation of the Authorization are vague. It mainly refers to non-compliance with “*a condition to which the Authorization is subject*”⁵⁴ and is subject to prior reasonable notice to the authorized person to give it the opportunity to cure the condition. This provision is considered adequate.

The Model PSA provides for other specific cases of early termination of the PSA, relative to (i) insolvency of the Contractor⁵⁵, (ii) a stop in production that lasts more than 12 months⁵⁶, (iii) unauthorized change of control⁵⁷, and more largely (iv) material default under the PSA for which the Contractor has not “*commence steps to remedy*” or does not “*proceed continuously to remedy*”⁵⁸. These provisions are usual practices. The Consultant recommends inserting other cases for termination as provided within this report (see **Sections 2.2.1, 2.3.1 of Part 2** and **Section 3.3.1 of Part 3** below).

3. HEALTH, SAFETY AND ENVIRONMENT (HSE) PROTECTION

This chapter refers not only to environmental concerns per se, but also covers issues relating to health, safety and the social environment, which need to be managed together as health and safety have an impact on the environment, which in turn has an impact on health and safety management.

Hydrocarbons exploration and production activities are regarded as hazardous as they tend to generate both latent pollution throughout all operational phases, as well as extensive pollution in cases where hydrocarbons operations or installations are not managed properly.

Such matters are crucial for the public authority and should be factored into the petroleum regime.

The best international practices favor an approach to set responsibility of environmental damages on the polluter, and force the potential polluter in the context of hazardous activities to assess properly the risks and take the necessary measures to avoid such pollution. It is usually referred to as the performance based policy. This approach is pragmatic. It is opposed to a prescriptive policy which approach is theoretical and consists for the public authority in setting specific measures to be taken.

More specifically, the public authority’s concern is also to make sure that the sites will be properly rehabilitated once the petroleum operations have expired.

53 See Article 19.14.10 of the 2008 Petroleum Law.

54 See Articles 23.4, 24.8 and 25.3 of the 2008 Petroleum Law.

55 See Article 2.4 of the Model PSA.

56 See Article 3.3 (a) (i) of the Model PSA.

57 See Article 21.2 (a) of the Model PSA.

58 See Article 2.4 (b) of the Model PSA.

3.1 Performance based policy

The 2008 Petroleum Law is mainly in line with the approach of a performance based policy adopted by the best international practices:

- Provisions of the 2008 Petroleum Law mainly present general principles listing specific damages to be avoided and referring to base line studies or environmental impact assessments to be conducted, “*in appropriate circumstances*”⁵⁹.
- The Model PSA also presents the general principles for proper conduct of petroleum operations with respect to environment and health and safety by the Contractor⁶⁰.
- With respect to assessment of risks, the Contractor is invited to submit “*an environmental impact statement and proposals for environmental management covering the life of the Development*”⁶¹ and “*Contractor’s proposal for ensuring the safety, health and welfare of persons in or about the proposed Petroleum Operations*”⁶² within the development plan.
- The Model PSA also requires the Contractor to remedy in a timely fashion any damage caused to the environment.

In this regard, the current petroleum regime of Somalia imposes on the Contractor, in accordance with international practices, the “*polluter pays*” principle. The person performing activities which may cause damage, in the context of petroleum operations, the operator shall prevent, mitigate and remedy the damages caused or that may be caused to the environment.

The law can be enhanced with further specifications on the various milestones at which environmental, health and safety assessment are compulsory. Moreover, the law should specify that such environmental assessment shall be submitted to the competent authority for approval⁶³.

In addition, the Somali petroleum regime does not set specifically, as usually inserted in petroleum or environmental regime, an absolute liability on the polluter, meaning a presumption of liability of the Contractor or the Authorization holder for any environmental damages resulting from the performance of its operations.

The underlining idea behind this absolute liability is: the more straight-forward it will be to seek the liability of the investor, the more the investor will be prompt to take better precautions to avoid environmental damage.

The Model PSA sets an obligation for the Contractor to “*indemnify and hold harmless the [Federal] Government from all claims of whatsoever nature which are brought against the [Federal] Government by any third party directly or indirectly*”⁶⁴. This principle is not specific to environmental damages. All the same, the Model PSA imposes on the Contractor to take out and maintain insurance but does not specifically refer to insurance on environmental risks.

59 See article 28 of the 2008 Petroleum Law.

60 See Article 5.1 of the Model PSA.

61 See Article 4.11 (d) (v) of the Model PSA.

62 See Article 4.11 (d) (vi) of the Model PSA.

63 Such requirements may also be specified in other laws or regulations applicable in Somalia such as the general environmental provisions.

64 Article 41 of the Model PSA.

The FGS does not have any guarantee that the investor will remain solvent where a significant damage arises. Environmental exposure is indeed very high with respect to petroleum operations. A leakage, for instance, can result in tremendous damages and amounts to remedy such damages. Somalia needs to set rules to be assured potential costs for remedy of any such damages will be paid by the investor.

Insurance is not sufficient to cover the entire potential risks, since no insurance company is willing to provide unlimited environmental damage cover. A maximum amount is always specified in the policy. Hence additional guarantees need to be put in place, such as bank or parent company guarantees. These again cannot cover the entire potential risks. Therefore, apart from the aforesaid solutions, an indemnification fund may be created.

At the international level, some funds already exist in particular with respect to marine environmental pollution, in particular the International Oil Pollution Compensation Funds (IOPC funds), established under the auspices of the International Maritime Organization (IMO), which allow for indemnification of damage caused by oil tanker oil spills. Somalia is not part to the relative conventions.

Apart from these funds which are limited to indemnification of damage caused by oil tanker oil spills, the current best practices are for the public authority to set a fund for environmental incident. Such fund is used by the public authority and operators to fund measures to be taken, for management of incident which may arise from any type of upstream petroleum operations, onshore or offshore. It can also be used to indemnify victims of such incident. Such fund can be constituted thanks to allocation by the public authority of part of revenue generated from petroleum operations or thanks to the creation of a specific contribution to be paid by any in the Authorization holders.

Recommendation: The Consultant recommends the following:

- 1- The laws shall set the principle of absolute liability of the investor where pollution arises.
- 2- The law shall set the various milestones at which environmental assessment shall be conducted and specify that the results of such assessment shall be submitted to the competent administration for approval.

Such milestones shall include the following:

- application for an Authorization, which shall require at the minimum a base line study. approval of its results shall be deemed upon granting of the Authorization;
 - before any significant petroleum operation, such as seismic study, drilling, development activities, an environmental impact study shall be conducted and various plans (environmental management plan, waste management plan, spill management plan, decommissioning plan) shall be established and submitted for approval to the administration.
- 3- The Authorization holder shall be obligated to update regularly such plan, on the basis of regular internal audits, which results shall be provided to the administration, to allow such administration to monitor environmental measures.
 - 4- The law shall specify the relevant competent administration. It can be a mere environmental administration or a specific petroleum administration.

- 5- The law shall impose on the investor to take insurance with a specific cover for environmental risks.
- 6- Finally the law may provide for a fund to be created for the management of environmental risks and refer to regulation for exact status of such fund, rules for use and management of such fund, and precision of the sources of funding of such fund. The law may with respect to this last point set the principle or the level of a contribution by the Contractors.

3.2 Site rehabilitation

The Somali current petroleum regime sets the main provisions usually found within petroleum regime with respect to decommissioning. The petroleum law may however be enhanced on some points.

The 2008 Petroleum Law sets principle of decommissioning. Under the definition of decommissioning in the current Somali petroleum regime, the aim of the work for decommissioning is the “*clean up the Authorized Area and make it good and safe and to protect the environment*”⁶⁵.

This purpose is rather limited in comparison to the purpose actually expected from decommissioning under the international practices. Decommissioning works shall also aim at favoring the (i) reappropriation of the site by local populations, via resumption of their social and economic activities carried out prior to the petroleum operations, and possibly by establishing suitable new social and economic activities; and (ii) restoration of the site’s flora and fauna.

The 2008 Petroleum Law envisages decommissioning upon “*termination of the Authorisation*” and “*in accordance with the conditions of the consent*”⁶⁶ which tends to indicate that the Authorization holder shall obtain a prior consent from the SPA to perform decommissioning.

In addition, the Model PSA provides for an obligation to “*carry out the Decommissioning Plan substantially in accordance with its terms*”⁶⁷. The decommissioning plan is submitted by the Contractor for approval of the Federal Government within the development plan and revised and resubmitted for approval by the Federal Government on a regular basis.

Such process for approval of the decommissioning plan, and regular updated versions, is in line with the usual practices. The Somali petroleum regime however seems to envisage decommissioning only upon expiry of the Authorization, if not only upon expiry of exploitation operations. It shall be set more clearly that decommissioning works shall be conducted on a regular basis, as soon as the considered infrastructures, or lands are no longer used for the purpose of petroleum operations.

The Model PSA also sets the principle that the decommissioning plan shall include the estimated amount necessary for its implementation and that the Contractor shall constitute, from the first year following the date of commercial production, a reserve of fund to finance the decommissioning plan. These principles are international best practices. They shall be set within the law. The precisions set in the Model PSA for calculation of the amount to be served each

⁶⁵ See article 28 of the 2008 Petroleum Law.

⁶⁶ See article 28 of the 2008 Petroleum Law.

⁶⁷ See Article 4.12 (d) of the Model PSA.

year for the constitution of the reserve are also in accordance with the international practices. They can be kept at the PSA level.

The Model PSA does not set any provision regarding management of such funds and refer to an agreement to be entered into between the Federal Government and the Contractor.

Recommendation: The Consultant recommends complementing the definition of Decommissioning to include broader objectives to such works, as mentioned above.

The law shall also be complemented to oblige the Contractor to set a decommissioning plan not only with respect to development activities, including infrastructures to be settled outside the contract area, but also with respect to any other specific petroleum operations which affects the environment. The petroleum regime shall specify that any environmental assessment study shall include resolutions for the decommissioning / rehabilitation of the lands that may be affected by the foreseen works and such resolutions shall include works to be performed at the soonest opportunity.

The Consultant recommends that the law sets the principle that the reserve fund shall be kept outside the accounts of the company, in the joint names of public authority and the Contractor (or in the name of the public authority alone) and within a national or international bank that is approved by the competent authority. Moreover, the model PSA may already set principles with respect to the management of such fund, as follows:

- the funds must not be released for any purpose other than to carry out the decommissioning works as approved in the decommissioning plan;
- the Contractor must submit a spending request to the competent authority;
- the competent authority must approve / all spending which is in accordance with the decommissioning plan and duly approved budget;
- the competent authority reserves the rights to refuse payment of any expense over and above the said plan and budget; and
- the amount remaining upon liquidation of such fund where the decommissioning is completed should remain to the public authority as the amounts served in the fund are recoverable costs under the Model PSA.

4. LOCAL CONTENT

A public authority shall ensure that local populations benefit as directly as possible of the petroleum operations.

It is necessary to implement genuine domestic development policies, which should be provided in the petroleum regime and should include measures guaranteeing economic and social gains for the country, and wealth creation that benefits local communities.

In a federation, the question arises of the territory to be considered. It could be either the nation level, meaning the Federal level, or the Member State level. This question shall be dealt with in the context of the Consultative Process.

Measures usually inserted in petroleum regimes to favor local content aim at (i) developing the expertise of local population through training, and (ii) favoring the recourse to local goods, services and employees. A new trend is also to (iii) set up agreements with local communities to determine with the population within the direct vicinity of the petroleum operations the measures to be taken by the investor to help the local development. Other measures aim at (iv) reserving part of the production for the local market; petroleum and gas are sources of energy which, when used locally, can allow the development of other activities.

The 2008 Petroleum Law does not set specific local content obligations. It merely refers to proposals to be made by the applicant to an Authorization⁶⁸ or to provisions to be set in the PSA⁶⁹.

The Model PSA sets a few concrete obligations on the Contractor.

The Somali petroleum regime shall include additional measures with respect to each of the above mentioned matters to enhance development of local content.

4.1 Training for development of local capacities

With respect to training, the Model PSA only imposes the payment of an annual training fee of 100,000 USD⁷⁰. The Contractor is also required to pay the “*local community benefit to be utilized by the [Federal] Government for the benefit of population of the Somali people within the vicinity of the Petroleum Operations*”. This contribution, which amounts to 500,000 USD during exploration and is then set as a percentage of the Contractor’s share of profit oil, could also be used for training purposes.

The Model PSA does not specify any obligation in terms of training to be provided by the Contractor, or objectives to be achieved in any such training. It does not even refer to program to be set, except with respect to the proposal to be submitted to the Federal Government together with the development plan⁷¹.

This part of the local content provisions should however be the main ones in the petroleum regime. Indeed, the main obstacle to achieving local content is the absence of the skills and abilities locally which are necessary to obtain jobs, or to develop local business, in the petroleum sector or in any other activities that could develop in tandem with the oil sector.

Contrary to what is provided for in the Model PSA, the international practices tend to put the liability of such training on the investor. It imposes the investor to submit an annual training program for approval, implement such program and report on the actual implementation and results achieved while implementing such program.

This is a remedy to situations where most amounts for training were not actually spent on training, due to misuse of the allocated amounts but also to the lack of local experts to provide such training. Moreover, the investors are more willing to meet their training obligations if it

68 Article 26.3.1.3, 26.3.1.4 and 26.3.1.6 of the 2008 Petroleum Law.

69 Article 24.6 of the 2008 Petroleum Law.

70 See Article 22.4 of the Model PSA.

71 See Article 4.11 (vii) of the Model PSA.

gives them the opportunity to train local manpower, which in the long term will save the investor money relative to the cost of employing expatriates.

Recommendation: The Consultant recommends modifying the provision of the Model PSA relative to payment of training fees. This provision shall be revised so that (i) the amount be negotiable and set as a result of negotiations in the signed PSA and (ii) it become a minimum expenditure requirement for training purposes instead of a minimum fees to be paid to the authority as a contribution to training. The future model PSA may set a minimum regulatory amount.

The petroleum law shall include provision for the annual submission to the competent authority for approval of a training program by the holder of a PSA.

Such programs shall be result oriented in consideration of the actual needs. They can include training sessions with specific objectives in terms of issues to be learnt or in term of position to be reached, training of specific individuals to enable them to reach specific positions in the company, and partnership with local entity for know-how transfer to local entities. This is all the more efficient those local stakeholders have the opportunity to put the knowledge they have acquired to immediate use expertise in related activities. Such programs are in that respect not purely independent from programs to promote the use of local goods, services and employment of local individuals.

For control purpose and also to help assessing efficiency of the programs, the petroleum regime also usually imposes submission of an annual report on the implementation of the training program.

4.2 Prioritizing recourse to local goods, services and employees

The Model PSA imposes a preference to the national goods, services and employees with an annual report to be submitted by the Contractor to the Federal Government to justify compliance to such preference requirement. This corresponds to measures usually set in petroleum regime in compliance with international practices.

The Model PSA refers to “*competitive terms and conditions*” with respect to goods and services or “*due regard to occupational health and safety requirement*” with respect to employment in petroleum operations⁷² as conditions to be met to allow preference to the local goods, services or employees. These conditions can be further detailed:

- With respect to employment, the occupational health and safety requirement can be maintained and will actually be well perceived by investors, but the law shall specify that preference is given to local individuals where they have similar or equivalent qualifications.
- With respect to goods and services, it is usually referred to similar terms and conditions of price, delivery, payment of the price and qualification of the subcontractor. Some countries impose a preference for local goods and services, even where the price is slightly higher (usually up to 10%) than the one offered by a foreign subcontractor. Such preferential treatment of local suppliers is usually not well considered by foreign investor. Where it would be introduced in the petroleum law, it shall be made very clear

⁷² See Article 5.4 of the Model PSA.

that such preference would only arise where the subcontractor offers the same qualification and delivery conditions.

These basic conditions shall be set within the law.

In any case, the investor shall be forced to invite local entities to tender for the acquisition of goods or services. The Model PSA requires that the Contractor “draw to the attention of suppliers based in Somalia, in such manner as the [Federal] Government agrees, all opportunities for provision of goods and services in Petroleum Operations”⁷³. This provision is relevant and should be maintained. It would in practice be limited to the sole cases where the Contractor will launch tender for selection of a supplier. It is important that it is complemented with provision imposing on the investor to recourse to tender for selection of goods and services, at least for contracts of a substantial amount. The Model PSA is not very clear on this point and shall be supplemented in this respect.

The tender documents shall clearly specify the selection criteria and procedures for such invitations to tender. This will enable Somalia to determine whether domestic companies have been assessed using the same criteria as foreign companies. Moreover, the tender requirement, together with the other communication requirement of Article 12 of the Model PSA, is a suitable way for the public authority to control that the company is being supplied at the best economic conditions, which allow a control on recoverable expenditures.

Finally, some petroleum regimes impose minimum quota of local goods, services or employees on the investor. This technique is used to force the investor to achieve results in the development of local content.

Such quota can only achieve their goals where capacities are sufficient locally. In this respect, as capacities in Somalia are limited for the moment, the Consultant would recommend not imposing quota yet. The public authority may within a few years of petroleum industry in Somali adopt regulation to start imposing any such requirement.

In the meantime, the best suitable approach from the Consultant’s perspective is to request the submission annually by the Contractor of a local procurement and employment plan, listing the measures to be taken during the year for promotion of local goods and services and for improvement of local employee rates, especially in high level positions. Such plan will have to be result oriented, as per training programs. The results to be obtained need to be set in an objective manner to allow monitoring of their achievement by the authorities. The report mentioned in Article 5.4 of the Model PSA will present measures taken during the year and results obtained, in comparison to commitments taken within such plans.

Recommendations: The Consultant recommends clarifying within the law the conditions for preference of local goods, services and employee in a more objective way, and keeping a strict preference at similar conditions, with no preferential treatment of local entities.

The Consultant also recommends setting in the petroleum regime an obligation for the Contractor to use competitive selection of subcontractors as set above.

The Contractor shall also be required to submit to the competent authority for approval an annual program for promotion of local goods and services and for employment of locals; such program

73 See Article 12 of the Model PSA.

being result oriented and results being determined in an objective way to allow proper monitoring by public authority.

4.3 Agreement for development of local content

The Model PSA imposes the Contractor to pay a contribution, the “*local community benefit*”, “*to be utilized by the [Federal] Government for the benefit of population of the Somali people within the vicinity of the Petroleum Operations*”. This contribution amounts to 500,000 USD during exploration and is then set as a percentage of the Contractor’s share of profit oil.

It is clear from this provision that the Federal Government will be responsible for the use of such contribution.

As mentioned above with respect to the training fees, the best international practices are now to favor direct initiative of the investor with respect to local content. The law in this respect shall set such payment requirement as a contribution to a fund to be used for the development of local communities, in accordance with the terms and conditions set in an agreement between the representatives of the Contractor and the local communities.

The scope of such agreement is usually broader than a mere program of expenditures. It also includes provisions for the management of such fund.

Recommendation: The Consultant recommends modifying the provisions regarding local community benefit. The payment obligation by the investor shall be set as a contribution to a fund to be used for the development of local communities, in accordance with the terms and conditions set in an agreement between the representatives of the Contractor and the local communities.

4.4 Local market provisions

The Model PSA sets rules for minimum contribution by the Contractor to the supply of the Somali national market, as may be necessary.

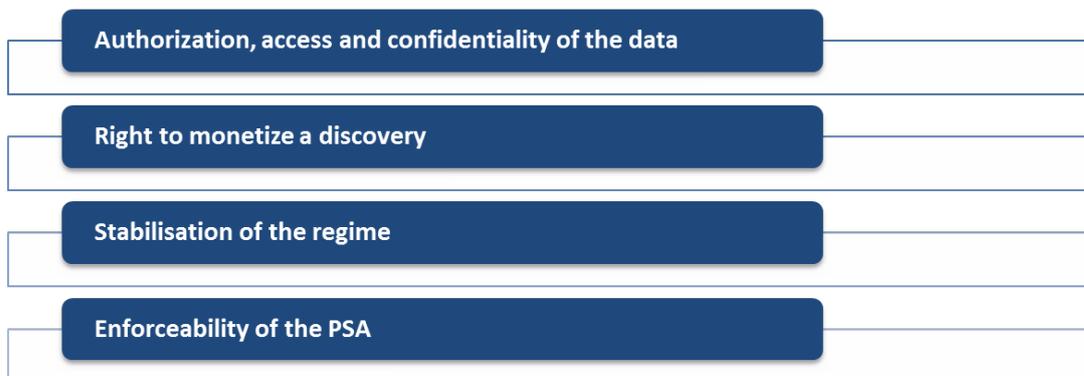
The provisions of article 9 of the Model PSA are in accordance with international practices. In particular, it is noted that the maximum contribution expected from the Contractor is proportionate to the share of petroleum produced from the contract area on the total production of petroleum in Somalia and is also capped to 25% of the total production from the contract area. Moreover the valuation of petroleum supplied to the Somali national market is the same as for valuation of petroleum for tax purpose.

Recommendation: The Consultant believes nevertheless that the PSA shall provide for sooner notice of the local market needs to the Contractor. Article 9.1 (a) of the Model PSA provides for a 30 days prior notice. Usual practices also provide for a notice annually or at least every six months to allow the investor to have more visibility on the share of production that is available for export.

PART 3 - INVESTOR'S MAIN CONCERNS

To attract investors, a public authority shall ensure that the petroleum regime provides the minimum guarantees expected from the investors to secure their investment. Indeed, petroleum operations involve significantly high investments which are at risks for the investor up to full recovery through exploitation.

In particular, the investor will check before investing in a specific jurisdiction that he is offered sufficient guarantee within the petroleum regime on its various concerns, which are as follows:



This **Part 3** reviews the current Somali petroleum regime, in the light of international practices, to identify whether the investor is being offered sufficient guarantees. As the case may be, the Consultant provides recommendations to Somalia for improving its current petroleum regime with respect to each of the above mentioned concerns.

1. AUTHORIZATIONS, ACCESS AND CONFIDENTIALITY OF THE DATA

In addition to the Authorizations, the investor needs to have access to various elements or be granted various authorizations to actually perform petroleum operations. The investor expects that Somalia will (i) facilitate such access or granting of such authorizations. Moreover, the investor expects to be given (ii) guarantee regarding access to the assets necessary for performance of the petroleum operations, including (iii) the data it collects and which shall be kept confidential.

1.1 Access to necessary rights to perform petroleum operations

The 2008 Petroleum Law sets rules (i) for prior approval of the SPA to exercise petroleum operations on public immovable or lands owned by Somalia and (ii) for prior compensation of the owner of the land which immovable rights are disturbed by the performance of petroleum operations⁷⁴.

Such rules are generally in accordance with international practices. They differ slightly, in particular as the 2008 Petroleum Law does not refer to possible expropriation to guarantee access by the investor to the lands, where such lands belong to a private entity. The Consultant notes however that the 2008 Petroleum Law does not require the prior consent of a private owner, but a mere compensation which is determined by the SPA.

74 See Article 30 of the 2008 Petroleum Law.

In this respect, it appears that the private owner is not in a position to refuse access to the land. The holder of the Authorization has sufficient guarantee to access the lands. Subject to other applicable laws in Somalia, the related provisions shall remain as such in the new petroleum law.

The 2008 Petroleum Law does not provide for rules as per lands on which locals have customary rights. Under the Model PSA, the Federal Government commits to “*make available to Contractor such land as may be reasonably required for the conduct of Petroleum Operations*”⁷⁵. Such commitment shall be considered as including a commitment from the Public Authority to take necessary measures, including expropriation or clearing of customary rights in accordance with applicable laws, to make available the necessary lands. The Consultant would recommend having such commitment inserted in the petroleum law, as well as above precisions to avoid doubt.

The current Somali petroleum regime also provides additional rights which are necessary for the performance of petroleum operations:

- access to structures, facilities within the contract area or communication facilities leading to it;
- use of raw materials and water.

Such guarantees are set within the Model PSA. To reassure the investor, the petroleum law may set a general guarantee that the holder of a PSA will be given authorization to use the above elements. Article 30.1.3 of the 2008 Federal Petroleum on the contrary may raise concern with the investor.

The Model PSA also includes a general guarantee that the Federal Government will “*assist Contractor in obtaining all permits, visas, approvals, consents, customs clearances, authorizations, rights of way, easements, licenses and renewals thereof from any government agencies in Somalia*”⁷⁶, including with respect to transportation “*approvals from other governments in Somalia whose approval may be needed for the construction, ownership and operations of any such pipelines and facilities*”⁷⁷. Such guarantees are essential to the investors and shall be kept within the Somalia petroleum regime, and additionally set at the legal level.

Recommendations: The Consultant recommends keeping the guarantees existing currently in the Somalia petroleum regime and inserting within the law the general guarantees provided for in the Model PSA that the public authority will facilitate delivery of the various necessary authorizations and that it will make available lands to the Contractor as necessary.

1.2 Access to assets necessary for performance of the petroleum operations

The question of the property of the assets acquired and used for the performance of the petroleum operations is not appropriately dealt within the current Somali petroleum regime.

No general guarantee against illegitimate expropriation of such assets is provided to the holder of an Authorization and its contractors, as usually stated under petroleum regime. The Model PSA sets that “*all structures, facilities, installation, equipment and other property, and other*

⁷⁵ See Article 23.1(a) of the Model PSA.

⁷⁶ See Article 23.1 (f) of the Model PSA.

⁷⁷ See Article 23.1 (i) of the Model PSA.

works used or to be used in Petroleum Operations, shall be and remain the property of the [Federal] Government while so used or held for use.”⁷⁸

This provision seems to indicate that all assets used for the performance of petroleum operations in Somalia shall be the property of the FGS, irrespective of whether the Contractor entered into exploitation. Considering this provision, the Contractor will favor rental of assets against acquisition. Indeed, the transfer of ownership on the assets does not apply, as confirmed under article 13.1 (b) of the Model PSA, to “*property leased to the Contractor*”. The recourse to rental of equipment, instead of acquisition in exploitation, is often more expensive and therefore, rental cost being treated as recoverable cost without limitation, reduces the revenue that will arise from petroleum operations.

Moreover, the Consultant notes that this provision is not combined with a guarantee for the Contractor that it will have the right to freely use such assets for its petroleum operations.

Under international practices in the context of a PSA, the question of the ownership of assets is dealt with differently depending on whether such assets are used for exploration or exploitation purposes. Indeed, as from the first year of production, the investor starts recovering costs incurred for the conduct of petroleum operations, including the costs for acquisition or rental of assets necessary for the conduct of exploration operations. However, before first production, the investor acquires or rent assets for the conduct of petroleum operations at its own risks.

In this respect, the public authority shall not be able to claim having any right on the assets acquired or rented by the investor during the exploration period. However, upon first production, as the public authority starts reimbursing costs associated to acquisition or rental of any such assets, the investor will accept that the public authority becomes owner of the assets that it acquired or will acquire and that it is recovering as associated costs. For the rest, the public authority shall guarantee to the investor and any of its contractor against any illegitimate expropriation.

Recommendations: The Consultant recommends inserting in the petroleum law a general guarantee against illegitimate expropriation.

With respect to ownership of the assets necessary for the conduct of petroleum operations, the law shall set that the Authorization holder is the owner of assets its acquires for the conduct of exploration operations, therefore excluding assets rented by the investor. The law shall add that, where exploitation operations are conducted, the ownership of such assets is transferred to the public authority. The moment for transfer of such assets can either be (i) the date at which associated costs of acquisition are recovered, which is the most attractive option to investor and also the most common option, or (ii) the date of entry of the assets in Somalia or of acquisition of the assets and the date of first production or approval of the development plan with respect to assets used during exploration. This second option is not as attractive but may be easier to manage for the petroleum administration.

This provision shall be accompanied with a guarantee for the investor that it can freely use assets which property has been transferred to Somalia and a general guarantee to the investor and its contractor that they shall not be subject to any illegitimate expropriation.

⁷⁸ See Article 13.1 of the Model PSA.

The Consultant also recommends inserting cost-efficient fiscal terms in order to create incentives for the investor to reduce cost of petroleum operations, including through favoring acquisition against rental if less expensive.

1.3 Confidentiality of the data

The 2008 Petroleum Law is compliant with international practices with respect to the status of data.

It provides for the Somali's ownership of all the data collected during petroleum operations and offers guarantees to the Contractor as follows: the right to keep copies of the data and use them "*in or in relation to Petroleum Operations*"⁷⁹, and the confidentiality of information where the Contractor would incur damage in case of disclosure of such information, up to a certain period.

The Model PSA additionally distinguishes information of commercial value, indicated as "trade secret", from other information and data collected and owned by Somalia. With respect, to the latter, the Model PSA provides for a time limit of five (5) years for the confidentiality obligation of Somalia. With respect to trade secret, Somalia shall keep such information confidential for as long as their communication may cause prejudice to the Contractor. The Federal Government may require the Contractor to justify that any specific information shall still be considered a trade secret. The five year limit is usual with respect to not specifically sensitive information. With respect to the trade secret, Somalia shall not remain bound by confidentiality after the expiry of the PSA. This shall be expressly set in the future model PSA.

Finally, the Consultant notes that the 2008 Petroleum Law includes rules for transparency of the petroleum sector which shall be kept within the updated petroleum law (see **Section 1.2 of Part 2**).

Recommendations: The Consultant recommends expressly setting in the model PSA that the Somalia obligation of confidentiality with respect to trade secrets shall in any case expire with expiry of the PSA.

2. RIGHT TO MONETIZE A DISCOVERY

As mentioned above, all investments during exploration are at risk up to recovery and potential return thank to exploitation of a commercial discovery. In this context, the investor needs to be certain that the public authority will not have a discretionary power to block the process and more generally the conduct of exploitation operations where a discovery is determined as commercial. Finally the investor needs guarantee that it can freely sell its share of production and recover the proceeds of such sale.

2.1 Commercial discovery and approval of the development plan

With respect to any discovery, the investor wants to be sure that it will be able to declare whether the discovery is commercially viable or not, and at least whether it will develop it or not.

The Model PSA leaves these two decisions to the Contractor⁸⁰, which is common practice in the oil industry.

⁷⁹ See Article 15 .2 (d) of the Model PSA.

⁸⁰ See Article 4.10 of the Model PSA.

The investor also wants guarantee that the approval of the competent authority on the development plan will not be unreasonably withheld. Indeed without such approval, the investor will not be able to exploit the discovery, even if commercially viable. The investor also does not want the public authority to force modification of the development plan which will end up in increasing the cost of the project beyond what is necessary and increasing its financial exposure.

These questions have already been discussed under **Section 2.2** of **Part 2** above. The petroleum regime shall be amended as mentioned above, as it is a little too investors friendly in this respect.

Recommendations: In particular, the Consultant recommends inserting a possible recourse to a third party technical expert which decision will be binding on the parties where the parties do not reach an agreement on the development plan within a certain period of time, following comments by the competent authority on such plan.

2.2 Limits on the control of the public authority - discretionary powers

As mentioned above under **Section 2.4** of **Part 2**, the public authority will control petroleum operations through participation in an operating committee and approval of the annual programs and budgets.

Recommendations given above for the conduct of such control take into account the guarantee that will be expected from the investor in the conduct of its operations, that the public authority may not discretionarily block exploitation.

2.3 Free sale of production and free disposal of the proceeds from such sale

The investor wants guarantee that it will be able to sell its share of production at market price. In this context, it needs assurances that it will be able to export its share of production, if there is no local market or if the sale on international market is more profitable.

The Model PSA allows the Contractor to market and sell petroleum and to conduct petroleum operations up to the Field Export Point which may be outside of the contract area and allow the Contractor to transport petroleum up to this point. In this context, the Contractor is given sufficient guarantee that it will be able to sell its production on the international market.

This guarantee is subject to the local market provision requirement. Such requirement is nevertheless in line with international practices, as mentioned under **Sections 4.4** of **Part 2**.

The provisions in the Model PSA relative to valuation of the production are appropriately balanced. The price of the production is set on an arm's length basis, which results in a fair and reasonable market price.

Finally, the Model PSA also provides guarantee with respect to foreign exchange rules applicable to the Contractor. In particular, the investor wants to be able to keep proceeds from the sale of production abroad and to transfer funds abroad, notably to its shareholders, if funds are in Somalia. Guarantees provided in this respect to the Contractor in the Model PSA correspond to such expectations of the investor and also to international practices.

Recommendations: It is recommended that foreign exchange principles be set in the law as they may be contradictory to other existing or future legislation.

3. ENFORCEABILITY OF THE PSA

The investor needs to make sure that the PSA offers appropriate guarantees for the enforceability of the contract. In particular, the PSA shall include applicable law and dispute resolution provisions and shall offer appropriate guarantees to the investor that the public authority will not terminate discretionarily the PSA, or use force majeure inappropriately.

3.1 Applicable law

The current Somali petroleum regime is in line with international practices on applicable law. It provides for application of “*the law of Somalia*” and of the “*principles of international law*”⁸¹.

The current Somali petroleum regime however does not indicate the prevalence of one set of rules over the other. Moreover the notion of “*principles of international law*” should be made more specific, referring to specific type of laws of the international practices.

Recommendations: The Consultant recommends modifying the notion of “*principles of international law*” to the notion of principle of international commercial laws, as petroleum agreements are related to commercial activities. Moreover, the Consultant recommends specifying that these principles shall apply where the law of Somalia is silent.

3.2 Dispute resolution provisions

In accordance with international practices, the 2008 Petroleum Law requires that the PSA includes “*provisions addressing [...] international arbitration*”⁸².

The Model PSA provides, with respect to (a) dispute relating to interpretation or implementation of the terms of the PSA, for (b) prior attempt to remedy the dispute through negotiations, (c) the rules to be applicable to arbitration and (d) the continuation of obligations under the PSA pending arbitration. The Model PSA does not provide for (e) the composition of the court, the place and the language for arbitration or (f) for rules waiving execution immunity.

In any case, arbitration process shall be distinguished from process for settlement of technical disputes, as may arise in the context of approval of a development plan. Such disagreement shall be settled by the recourse to an independent technical expert which decision is binding on the parties, subject to review through arbitration.

a) Type of disputes admissible to arbitration

The Model PSA limits the type of disputes that are admissible for arbitration to disputes arising in relation “*to the interpretation or implementation of the terms of this Agreement*”⁸³.

This enumeration risks leaving others types of disputes, such as disputes arising in relation to termination of the PSA, outside the scope of arbitration.

Recommendation: The Consultant recommends modifying this enumeration to a broader formula referring to disputes arising from or in relation to the PSA. This formulation can be

81 See Article 24.3 of the Model PSA.

82 See Article 24.6 of the 2008 Petroleum Law.

83 See Article 14.1 of the Model PSA.

complemented with indication that it is including disputes in relation to the interpretation, implementation or termination of the PSA.

b) Prior attempt to remedy through negotiation

The Model PSA sets the prior requirement for submission to arbitration that the parties try to settle the dispute through negotiations but does not provide for any specific period of negotiations, or any minimum number meetings, to try remedying the situation.

Recommendation: The Consultant recommends adding a minimum period [60 days] during which the parties shall meet [at least once] to try settling the dispute.

c) Rules to be applicable to arbitration

As a first option, arbitration shall be conducted in accordance with the rules of the International Center for Settlement of Investment Disputes (ICSID).

Application of the ICSID rules is subject to restrictions pursuant to Article 25 of the Washington Convention that established the ICSID:⁸⁴ “*The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre.*” Hence for application of ICSID rules to dispute resolution arising in relation to the PSA, Somalia and the investor’s country of origin must both be contractors of the Washington Convention, and be nationals of two different countries.

Somalia ratified the Washington Convention dated 18 March 1965. The choice for ICSID rules is adequate. It is also the most protective for both parties by virtue of the fact that ICSID rulings are not subject to appeal in national jurisdictions.

It is however often the case that the investing company is a national of the host country where the investment was made, and thus the dispute opposes a country and a company that is national of the same country. In this case, it shall be specified, to allow application of the ICSID rules, that the parties agree that the company shall be regarded as a foreign entity, from a jurisdiction to specify, by virtue of the foreign control exercised over such party. All the same, where the PSA shall be signed with a Member State, it shall be specified that the signing public authority shall be regarded as a member of the FGS who is contractor of the Washington Convention.

The Model PSA also sets other options for the rules applicable to arbitration. Such options are so large that the parties appear not to have determined the rules for arbitration.

Recommendation: The Consultant recommends that the parties actually choose between the various options set in the Model PSA before execution of the PSA, and prefer application of ICSID rules. It shall be specified in this respect in the future model PSA that the parties shall choose one of the proposed options upon execution.

84 Convention On The Settlement Of Investment Disputes Between States And Nationals Of Other States Done at Washington, 18 March 1965

Where the parties choose application of ICSID rules and where the investor is a Somali company, it shall be specified that the parties agree to consider it as foreign, by virtue of the foreign control exercised over such party.

d) Continuation of obligations under the PSA pending arbitration

The Model PSA is compliant with international practices in this respect.

e) Composition of the court, place and language for arbitration

The Model PSA does not set rules regarding place and language for arbitration. It does not set rules for composition of the court for arbitration either.

The investor wishes a place that will protect him from interference of the host-country's judicial system. In this respect, the investor usually prefers a neutral place of arbitration, meaning a place that is situated outside the jurisdiction of the host-country and of the company.

The ICSID being the preferred rules for arbitration, the investor will also benefit from protection resulting from the fact that ICSID rulings are not subject to appeal in national jurisdictions. Moreover, the ICSID rules set provisions for the composition of the court for arbitration. Therefore there is no need to set provisions in this respect in the future model PSA.

Finally with respect to language, it is recommended to choose one unique language. The Model PSA is in English and sets that English shall prevail where the PSA would be translated in other language. Although this can be discussed, it is preferable that the law of arbitration be the same as the law of the contract, it facilitates the interpretation of the provisions of the PSA, thus the resolution of disputes. In any case, where Somalia shall be the prevailing language, the PSA shall be translated into English and even negotiated into English. Concerning the language of arbitration, the Consultant recommends preferring English in any case.

Recommendation: The Consultant recommends favouring the ICSID rules with a neutral place of arbitration. Finally, the Consultant recommends preferring English for the language of arbitration.

f) Rules waiving execution immunity

In addition to the host-country waiving their jurisdictional immunity (pursuant to the dispute settlement clause), the investor prefers jurisdictions where the host-country also agrees to waive its immunity from execution.

Under the current Somali petroleum regime, Somalia does not provide such guarantee to the investor.

Although States may be reluctant to waive their immunity from enforcement for various reasons, the above provisions are reassuring for investors and lend weight to the arbitration clause. In this case, the investor can indeed seize the host-country's assets if necessary in order to enforce a ruling in its favor.

In any event, when it comes to commercial contract, many foreign jurisdictions uphold the concept of arbitration rulings being enforceable in their jurisdiction, even in cases where the host-country which is subject to the ruling has not waived its immunity from enforcement of the arbitral award. Thus, it shall be preferred to set clearly the renouncement by the public authority to its immunity from execution.

Recommendation: The Consultant recommends, in order to better attract investors, setting an express renouncement by the public authority to its immunity from execution.

In any event, Somalia shall note that, when it comes to commercial contract, many foreign jurisdictions uphold the concept of arbitration rulings being enforceable in their jurisdiction, even in cases where the public authority who is subject to the ruling has not waived its immunity from enforcement of the arbitral award.

3.3 Termination of the PSA

The investor wants to be sure that (i) the public authority cannot withdraw discretionarily its petroleum rights. It also wants to be able to (ii) renounce to its rights unilaterally.

In any case, it shall be underlined that, pursuant to international practices, the current Somali petroleum regime sets that any such termination or renouncement by the Contractor is “*without prejudice to rights and obligations expressed in the Law, the Regulations or the Authorization to survive termination*”⁸⁵. This includes among others, the obligation of the Authorization holder for decommissioning, as specified under the Model PSA⁸⁶.

3.3.1 Termination by the public authority

The 2008 Petroleum Law sets a general case for termination by the FGS of the PSA as follows: “*at any time by written notice to the holder, if the holder has not complied with a condition to which the Authorization is subject after giving the holder a reasonable opportunity to cure the condition*”⁸⁷.

The process for termination in this case is complemented within the Model PSA as follows: “*the [Federal] Government may terminate this Agreement on ninety (90) days notice to Contractor if Contractor is in material default under this agreement and does not, within that ninety (90) days, commence steps to remedy the default, and proceed continuously to remedy the default to the satisfaction of the [Federal] Government*”⁸⁸.

This general case is in line with international practices. It limits the possibility for the FGS to withdraw petroleum rights to material default and gives the investor the opportunity to remedy.

Apart from this general cases, the current Somali petroleum regime provides for potential withdrawal by the FGS of the petroleum rights where:

- insolvency and other similar situations faced by the Contractor⁸⁹; and

85 See Article 40 of the 2008 Petroleum Law.

86 See Article 2.5 of the Model PSA.

87 See Articles 23.4.2, 24.8.2 and 25.3.1.2 of the 2008 Petroleum Law.

88 See Article 2.4 (b) of the Model PSA.

89 See Article 2.4 (i) to (iv) of the Model PSA.

- a change of control occurs without the prior consent of the SPA⁹⁰.

Such termination, although not clearly specified under the current regime, shall require prior notice to the authorized person.

The Model PSA complements possible cases of termination by the FGS with cases where the Contractor is deemed having renounced to its petroleum rights, or relinquished the contract area:

- where the Contractor has not relinquished part of the contract area before expiry of the current exploration period;
- where production from the development area [is] ceasing permanently or for a continuous period of twelve (12) months⁹¹.

The deemed relinquishment of the contract area, appears as a sanction of the Contractor for in execution of its obligations and a more straight forward way for the FGS to terminate the PSA. It does not require prior notice to the Contractor. In this respect, the cases for such measure shall be strictly limited and set in an objective way to avoid contestations.

The cases listed in the current petroleum regime of Somalia respect these requirements.

Recommendations: The Consultant mentioned in the above **Section 2.2.1 of Part 2** other cases of deemed relinquishment that it recommends inserting in the law or the Model PSA.

3.3.2 Renouncement by the Authorization holder to its rights

The 2008 Petroleum Law provides with respect to each type of Authorization, that such Authorization “*may be surrendered by the holder by written notice to the SPA, provided that the Authorised Person has fulfilled all its obligations thereunder*”⁹². This includes obligations for decommissioning and is compliant with international practices. With respect to exploration, the Contractor shall also be obliged to complete the minimum work program for the current exploration period or pay the penalty for nonperformance of the minimum work program.

The Model PSA however contradicts the above provisions indicating that “*without the consent of the [Federal] Government, Contractor may not otherwise (meaning except for production ceasing permanently or for more than 12 months) relinquish all or part of a Development Area*”.

This last provision of the Model PSA is not compliant with international practices and shall be deleted. The Contractor shall be able to renounce to its petroleum rights including during exploitation. Such renouncement may be subject to certain conditions such as notification, but not to a prior consent of the public authority. A specific process may however be set within the regulation to allow control by the public authority that the Contractor has complied with its obligations before the Contractor being definitely released.

⁹⁰ See Article 31.2.3 of the 2008 Petroleum Law and Article 21.2 of the Model PSA.

⁹¹ See Article 3.3 of the Model PSA.

⁹² See Articles 23.4.1, 24.8.1 and 25.3.1.1 of the 2008 Petroleum Law.

Recommendations: The Consultant recommends deleting the provisions limiting relinquishment of the development area in other circumstances as listed under article 2.4 of the Model PSA.

3.4 Force majeure clause

In compliance with international practices, the Model PSA includes a force majeure clause.

The definition of event of force majeure, as well as the process to be followed and the consequences of the force majeure, set in these provisions are compliant with international practices.

Contrary to force majeure clause in previous petroleum agreements in Somalia which expressly provide for automatic extension of time for performance of obligations, force majeure clause in the Model PSA invites the parties to find an agreement, where the force majeure event would last more than three months, for amending the terms of the agreement, including for agreeing on new period of time for carrying out Petroleum Operations, as may be necessary.

The international principle of extension of time period to perform obligation during force majeure event shall nevertheless apply. The conventional approach sets under the Model PSA for agreement on a new period of time to perform obligation shall be maintained.

Recommendations: This provisions relating to Force Majeure do not need to be modified.

4. STABILITY OF THE REGIME

In addition to protection against unforeseeable circumstances under force majeure clauses, the investor requires protection against unilateral modification by the public authority of the applicable regime. In this respect, the PSA usually includes a stabilization clause.

4.1 Stabilization clause

The petroleum law usually provides for the possibility with respect to petroleum agreements to insert stabilization clauses, thus giving legal basis to protection inserted in such clauses. The 2008 Petroleum Law does not set any provision relative to possible stabilization of the regime applicable to an Authorization.

The Model PSA nevertheless includes stabilization provisions.

Under article 23.2 of the Model PSA, the Federal Government guarantees to the Contractor the stability of the terms and conditions of the PSA, and of the tax and fiscal framework in force when the PSA is entered into. The Federal Government commits not to introduce or alter the terms and conditions on the PSA or the tax and fiscal frameworks applicable to such PSA in a manner which would negatively affect the economic balance of the PSA.

The stabilization offered to the investor under the Model PSA relates to (i) all the terms and conditions of the PSA, and (ii) the tax and fiscal legal framework in force in Somalia at the date of entry into force of the PSA. The mechanisms set in the stabilization clause under the Model PSA aims at compensating the only financial and economic effects of any changes in applicable laws.

Article 23.2 of the Model PSA specifies that in case any changes occurs the Federal Government shall, at the Contractor's election, either (i) amend the fiscal features of the PSA in order to restore the initial fiscal balance of the PSA or (ii) allow the costs and expenses associated with such altered terms and conditions of the PSA or altered tax and fiscal framework to be included as recoverable costs. In this respect, new legislation on environmental, health and safety matters, for instance, will be applicable to the Contractor but additional costs and expenses related to implementation of the new legislation will be inserted as recoverable costs.

These two options set under the Model PSA correspond to a combination of mechanisms found in the stabilization clauses under international practices: it includes (i) automatic compensation of the investor by the public authority of additional costs incurred as a result of the change in the conditions where (ii) an amendment of the PSA, subsequently to a renegotiation of the PSA to restore the initial economic balance, has not been entered into yet.

The stabilization offered under the Model PSA shall last the entire duration of the PSA. This corresponds to international practice and shall be kept as such. Indeed, although some petroleum regimes have inserted limited period of time for stabilization (for instance: 10 years as from first commercial production), such limitation is not usual in similar jurisdiction as Somalia, and will as such deter investors from entering a PSA.

Recommendations: The Consultant has no specific recommendations with respect to the stabilization clause, as it is compliant with international practices. The Consultant however recommends inserting in the law the principle that petroleum agreements can include stabilization clauses which aim at maintaining the initial financial and economic balance of the agreement.

4.2 Transitional provisions

In the context of the adoption of a new petroleum law to replace the 2008 Petroleum Law, transitional measures need to be inserted to address the cases of existing petroleum rights in Somalia.

It appears from discussions during the kick-off workshop that no PSA has been entered or Surface Authorization has been granted under the 2008 Petroleum Law, and that Reconnaissance Authorizations have been granted which are now expired.

Moreover, Somalia indicated that an audit has been conducted to identify the petroleum agreements that have been entered into under previous legislation, and whether they are still in force. Indeed, contracts have been entered into under previous legislation and most of the concerned contractors have declared force majeure upon occurrence of the 1991 events, in Somalia. The main issue in relation to these agreements is to determine whether the contracts have expired or not despite the force majeure circumstances and whether the concerned investors wish to resume petroleum operations, where it would be considered force majeure circumstances no longer exist.

The Consultant is not in a position to assess the current situation with respect to existing agreements in Somalia. The Federal Government of Somalia did not provide the Consultant with the results of the above mentioned audit, or with an exhaustive view of the previously executed contracts and of the situation with the respective contractors.

Provisions under the 2008 Petroleum Law provides for the conversion of “*Prior Grants*”, meaning “*rights granted by the Somali Democratic Republic on or before December 30, 1990*”, “*into the form of Authorization that is most similar to the Prior Grant*”⁹³. On the contrary, the Transitional Federal Republic of Somalia does not recognize grants which are post-1990. The 2008 Petroleum Law provides for immediate termination of these agreements.

The holder of Prior Grants are given a period of one year from the coming into force of the 2008 Petroleum Law to convert their grants. Failure to achieve such conversion within this period of time results in termination of the Prior Grant.

The 2008 Petroleum Law enters into force “*on the day after its publication in the Gazette*”⁹⁴. The Consultant has not been provided with the version of this law published in the Gazette and therefore has no exact date for starting computation of this delay. The law was promulgated by the President of the Transitional Federal Republic on August 7th, 2008 and the act of the President provides for entry into force on August 7th, 2008.

The law also offered protection to the holder of Prior Grant, indicating that the Ministry of Petroleum shall make reasonable efforts to contact “*Prior Contractor*”, so far as it is able to determine who they may be.

In this context, the Prior Grant which has not been converted before August 8th, 2009 shall be considered terminated.

Nevertheless, it appears from discussions during the kick-off meeting that Somalia is currently in discussions with contractors of existing contracts for conversion of such contracts.

Recommendations: The Consultant recommends that transitional measures to be inserted in the new petroleum law either (i) set that pursuant to article 59.3 of the 2008 Petroleum Law, the Prior Grant are considered terminated or (ii) provides for an additional period for achieving such conversion, taking into consideration specific circumstances and with respect to contractors which manifested their interest for such conversion. Alternatively, it can be conventionally agreed with the contractors currently under discussions with the Ministry of Petroleum that certain petroleum costs which were incurred previously will be taken into consideration within a new Authorization to be granted under the new law.

93 See Article 59.1.1 of the 2008 Petroleum Law.

94 See Article 60 of the 2008 Petroleum Law.

PART 4 - FINANCIAL AND FISCAL ISSUES

The objective of **Part 4** of the Provisional Report is to provide guidance to the competent authorities for updating the fiscal framework of the petroleum sector of Somalia.

As outlined in our Inception Report and based on available information, the existing general fiscal framework in Somalia is not represented by any structured official legislation mandating direct or indirect taxation of individuals or businesses. Our recommendations are therefore based on the principle that the fiscal framework for the petroleum operations will need to address the absence of the general fiscal framework in Somalia, and it is unlikely that a general fiscal framework will be duly implemented in the short or mid-term.

For the purposes of this Provisional Report (similarly to the preceding Inception Report), our analysis relating to the petroleum operations is limited to upstream activities only.

By taking into consideration the findings and recommendations presented and discussed at the kick off workshop in Nairobi during November 2015, we have prepared this **Part 4** of the Provisional Report that outlines our recommendations for updating the fiscal petroleum framework in Somalia.

For the purpose of comparative assessments for each fiscal term below, we have selected four countries, being Kenya, Mozambique, Tanzania and Yemen, as the countries that are most active in petroleum activities in the peer group of countries that were analyzed in the Inception Report. Please note that such comparative assessments of the fiscal terms should not be considered on a stand-alone basis but in conjunction with all other fiscal terms representing the overall applicable fiscal regime in the considered countries.

1. PROPOSED OIL AND GAS FISCAL FRAMEWORK

1.1 Overview

The proposed fiscal framework is based on the following principles which reflect the objectives for the updated oil and gas fiscal framework in Somalia:

- ▶ Progressive taxation of petroleum upstream operations (i.e. taxation is proportionate to the profitability of the operations);
- ▶ Simple-to-administer regime;
- ▶ Hybrid regime: single source of petroleum legislation and fiscal terms (i.e. petroleum law) with some variables to be specified in a petroleum contract;
- ▶ Fiscal terms applicable to petroleum upstream operations will be solely the one envisaged by the petroleum law and the petroleum contract; no other taxes, fees or similar payments will be applicable to petroleum upstream operations;
- ▶ Attractive fiscal terms compared to the neighboring countries taking in account the frontier status of the Somali petroleum opportunities.

The proposed fiscal regime is based on the fiscal features summarized in the table below.

Fiscal feature	Main details
Royalty	10% for the value of produced oil and condensates 5% for the value of produced natural gas
Cost recovery	70% recovery cap, unlimited recovery within the cap
Profit petroleum sharing	Formula (based on R-factor): Cumulative Contractor's (Cost Oil + Cost Gas + Profit Oil + Profit Gas) / Cumulative Contractor's (CAPEX + OPEX) Rates (Somali share): <ul style="list-style-type: none"> ▶ 20% for $R \leq 1.0$ ▶ Linear R-factor for $1.0 < R < 2.0$ ▶ 85% for $R \geq 2.0$
Corporate taxes	Contractors: the Somali royalty and share of profit oil / gas are in lieu of corporate income tax, with no additional corporate income tax payable by the contractor. If required, a certificate will be provided to the contractor confirming that corporate income tax of 35% on the investor's share of profit oil or gas has been paid by the public authority on behalf of the contractor. Subcontractors: 5% withholding tax for non-resident and 3% for resident 20% capital gains tax which is levied directly on the investor farming out from a project. The capital gain will target interest disposals for cash rather than for disproportionate work commitments.
Signature bonus	Biddable, but minimum US\$ 200k. Non-recoverable
Surface rentals	Exploration phase: US\$ 10 per sq. km, Development and production: US\$ 100 per sq. km Both are recoverable
Training contribution	Annual training contribution of US\$ 200k. Recoverable
Local community contribution	Annual fee of US\$ 200k until production starts, US\$ 500k annually thereafter. Recoverable
State participation	Up to 25% maximum Carried through exploration, full equity thereafter

1.2 Petroleum revenue allocation

Somalia is a federal State; therefore the question of allocation of revenue from hydrocarbons needs to be addressed. The petroleum revenues in Somalia could be either collected at the Federal level and shared with the Member States; or be collected respectively by the FGS or the Member States pursuant to allocation of specific tax bases arrangements. The Consultant and EY Counsel hereby refer to the Consultative Process as per the decision on the petroleum revenue allocation mechanism.

The table below provides a comparison between the current fiscal terms and the proposed fiscal terms for Somalia.

Fiscal feature	Current fiscal terms (Model PSA)		Proposed new fiscal terms																									
	Oil/ oil field	Gas/ gas field																										
Signature bonus	Biddable/negotiable (Art. 22.1). Recoverable: potentially yes (Art. 3.9 of accounting procedures – hereinafter “AP”)		Biddable, but minimum US\$ 200k. Non-recoverable																									
Production bonus	5-tier scale linked to cumulative production. Conversion for gas is 6 mcf per 1 bbl. \$ 1mln for 1k bbl., US\$ 1.5mln for 50k bbl., US\$ 2mln for 100k bbl., US\$ 3mln for 150k bbl., US\$5mln for 200k bbl. (Art. 22.2) Recoverable: potentially yes (Art. 3.9 of AP)		Not applicable in the proposed framework																									
Rentals	US\$ 10 per sq km during exploration, US\$ 100 per sq km during development and production (Art. 22.3) Recoverable: yes (Art. 3.9 of AP)		Unchanged																									
Training contributions	US\$ 100k per year through the term of the agreement (Art. 22.4) Recoverable: yes (Art. 3.13 of AP)		US\$ 200k per year. Recoverable. The contribution has been increased to cover for the costs that the SPA will incur to audit operator’s accounts and fiscal calculations.																									
Royalty	<p>Linked to daily production and prices (P).</p> <table border="1"> <thead> <tr> <th>BOPD \$/bbl</th> <th>P < 35</th> <th>35 < P < 45:</th> <th>45 < P < 55</th> <th>P ≥ 55</th> </tr> </thead> <tbody> <tr> <td>First 25k</td> <td>2%</td> <td>4%</td> <td>6%</td> <td>8%</td> </tr> <tr> <td>25k+ – 50k</td> <td>4%</td> <td>6%</td> <td>8%</td> <td>10%</td> </tr> <tr> <td>50k+ – 100</td> <td>6%</td> <td>8%</td> <td>10%</td> <td>12%</td> </tr> <tr> <td>100k+</td> <td>8%</td> <td>10%</td> <td>12%</td> <td>14%</td> </tr> </tbody> </table> <p>The royalty rates for natural gas are the same as those for crude oil with 1 bbl = 4 Mcf and the gas price on a 10:1 basis (Art. 7.1(c), 7.1(d))</p>		BOPD \$/bbl	P < 35	35 < P < 45:	45 < P < 55	P ≥ 55	First 25k	2%	4%	6%	8%	25k+ – 50k	4%	6%	8%	10%	50k+ – 100	6%	8%	10%	12%	100k+	8%	10%	12%	14%	Flat rates: 10% for oil and condensates 5% for natural gas
BOPD \$/bbl	P < 35	35 < P < 45:	45 < P < 55	P ≥ 55																								
First 25k	2%	4%	6%	8%																								
25k+ – 50k	4%	6%	8%	10%																								
50k+ – 100	6%	8%	10%	12%																								
100k+	8%	10%	12%	14%																								
Cost recovery ceiling	40% net of royalty (Art. 7.1(e).i)	60% net of royalty (Art. 7.1(e).ii)	70% for both oil and gas																									
Brief cost recovery rules	Subject to cost recovery ceiling, all major costs (exploration, appraisal, capital and operating expenditure) are allowed for recovery in full without additional limitation (e.g., requirement to capitalize certain costs and recover through depreciation over a number of years) (Art. 6.2)		Unchanged																									
Profit petroleum Sharing	<p>Linked to daily production and prices (P). Somali share (Art. 7.1(h)):</p> <table border="1"> <thead> <tr> <th>BOPD \$/bbl</th> <th>P < 35</th> <th>35 < P < 45:</th> <th>45 < P < 55</th> <th>P ≥ 55</th> </tr> </thead> <tbody> <tr> <td>First 25k</td> <td>55%</td> <td>60%</td> <td>65%</td> <td>70%</td> </tr> <tr> <td>25k+ – 50k</td> <td>60%</td> <td>65%</td> <td>70%</td> <td>75%</td> </tr> </tbody> </table>		BOPD \$/bbl	P < 35	35 < P < 45:	45 < P < 55	P ≥ 55	First 25k	55%	60%	65%	70%	25k+ – 50k	60%	65%	70%	75%	Profit sharing based on overall project’s profitability by way of measuring an R-factor.										
BOPD \$/bbl	P < 35	35 < P < 45:	45 < P < 55	P ≥ 55																								
First 25k	55%	60%	65%	70%																								
25k+ – 50k	60%	65%	70%	75%																								

Fiscal feature	Current fiscal terms (Model PSA)					Proposed new fiscal terms
	Oil/ oil field		Gas/ gas field			
	50k+ – 100	65%	70%	75%	80%	<p>R-factor formula:</p> <p>Cumulative Contractor’s (Cost Oil + Cost Gas + Profit Oil + Profit Gas) / Cumulative Contractor’s (CAPEX + OPEX)</p> <p>Rates (Somali share):</p> <ul style="list-style-type: none"> ▶ 20% for $R \leq 1.0$ ▶ Linear R-factor for $1.0 < R < 2.0$ ▶ 85% for $R \geq 2.0$
	100k+	70%	75%	80%	85%	
	The royalty rates for natural gas are 10 percentage points less than those for crude oil with 1 bbl = 4 Mcf and the gas price on a 10:1 basis (Art. 7.1(i))					
	Mcf/d \$/mbtu	P < 3.5	3.5 < P < 4.5	4.5 < P < 5.5	P > 5.5	
	First 25k	45%	50%	55%	60%	
	25k+ – 50k	50%	55%	60%	65%	
	50k+ – 100	55%	60%	65%	70%	
	100k+	60%	65%	70%	75%	
Special/other resource taxes	Local Community Benefit: US\$500k per year until production start; thereafter a percentage of the contractor's Profit oil/gas, linked to oil (\$/bbl) or gas price (\$/mmbtu) - (P): Recoverable: yes (Art. 7.1(j))					Annual Local Community contribution of US\$ 200k annually until the start of production, US\$500,000 annually thereafter. Cost-recoverable
	10%, for $P < 3.5$; 15%, for $3.5 < P < 4.5$; 20%, for $4.5 < P < 5.5$; and 25%, for $P > 5.5$.		10%, for $P < 3.5$; 15%, for $3.5 < P < 4.5$; 20%, for $4.5 < P < 5.5$; and 25%, for $P > 5.5$.			Not applicable in the proposed framework
State participation	Up to 40% from the start of development. No obligation to repay prior costs. The 40% could be split between a regional Member State company (1/3) and the FGS company (2/3) (Art. 8)					Up to 25% anytime. Carried through exploration, full equity thereafter To be held by a single National Oil Company (NOC)
Other: various fees	Contains a reference to the Fees envisaged in the 2008 Petroleum Law (Art. 11.1) Recoverable: no (Art. 2.7 (o) of AP)					Removed.
Corporate income tax (CIT)	Not addressed, act to state that it is not cost recoverable (Art. 2.7 (h) of AP)					In practice not levied in cash (concept of “Tax paid PSA”), and considered as

Fiscal feature	Current fiscal terms (Model PSA)		Proposed new fiscal terms
	Oil/ oil field	Gas/ gas field	
			<p>included into the country's share of profit petroleum. Nominal rate is 35%. Tax credit certificate available.</p> <p>For subcontractor - 5% withholding tax for non-resident and 3% for resident</p> <p>Capital gains are actually taxed at 20% rate</p>
Interaction with taxes/levies that may apply or be established outside of the Model PSA or the 2008 Petroleum Law	<p>Not addressed with respect to potential issues once the contract is signed (whether anything outside of the Model PSA/2008 Petroleum Law applies to an investor), i.e. on Effective Date. The Stability provisions (Art.23.2) address potential issues after the Effective Date</p> <p>The definitions include term tax which means "any income tax, duty, levy or other charge, whether imposed by the Federal Government or by the Government [Transitional Federal Government], but excluding any value added tax". The term is mentioned in Art. 2.7 of AP as non-recoverable cost</p>		Exemption
Imports/export duties	Exemption for equipment, supplies and materials required for conducting petroleum operations (Art. 23.1(g))		Exemption
VAT or alike taxes	Not directly addressed. Expressly excluded from the definition of a tax (Definitions)		Exemption
Other general taxes (e.g., property tax, taxes levied by regions)	Not addressed, other than they are not recoverable. (Art. 2.7 (h) of AP)		Exemption

2. VALUATION OF PETROLEUM

As a separate item we are commenting on the valuation of petroleum that should be used for royalty calculation purposes, petroleum sharing purposes and overall petroleum operations.

The valuation provisions for crude oil and natural gas as currently addressed in the Model PSA are generally robust and could be used in the future. However, the provisions could be detailed at the drafting stage to narrow down the valuation to an appropriate benchmark crude oil (e.g. BRENT) depending on the destination for the produced oil and condensates from Somalia.

For the purposes of royalty calculations, cost recovery and the production sharing, the petroleum (both crude oil and natural gas) could be valued at an applicable price (as per evaluation provisions of the existing Model PSA) at Field Export Point. The Field Export Point is set as part of the development plan. Setting it at the field boundary will mean that any midstream transport costs are not allowable for cost recovery but are deducted in the valuation of petroleum. Alternatively, setting it at the offtake end of a dedicated pipeline will mean that the costs of the pipeline are included as allowable for cost recovery and the cost oil and profit oil calculations, but no adjustment is required to the valuation of petroleum. The precise Field Export Point will need to be agreed as part of the development plan for the field: this cannot be pre-determined as it will depend on the field characteristics and infrastructure available.

3. ROYALTY

Introduction

Royalties are the most common and well-spread fiscal feature applied by countries to upstream operations. Royalties are levied on production or gross revenue and can be either fixed or variable. Typically they do not take into consideration the costs of extraction and are based on gross revenues (gross royalties), but may include a profit element. Variable royalties can be linked, for example, to cumulative or daily production, oil and gas prices, R-factor, or a combination of factors.

Gross royalties are reasonably predictable and easy to administer (unless complicated sliding scales are implemented). Royalties are usually payable based on physical quantities (e.g. 10% of oil produced), but are generally payable as the equivalent monetary value. The petroleum contract will need to specify where the oil is to be measured (e.g., delivery point, or export point) as this will impact the treatment of transport costs and will need to specify how the value of oil is to be measured, generally based on selling or market prices netted back for transport costs).

Royalties increase the marginal cost of extracting oil and gas. Royalties are typically levied throughout a project's life, starting as early as commercial production begins. Royalties reduce an investor's incentive to invest in a project, and as a result, may lead to the premature abandonment of a field, or may deter investments in marginal fields. Royalties are generally regressive, unless a strong profitability element is present, or if the overall fiscal framework includes progressive fiscal features with the royalty share being relatively low.

Royalties in a PSA environment need to be considered in conjunction with the cost recovery limit.

Recommendation

The Consultant recommends relatively low gross royalties with differentiated rates of 5% for natural gas and 10% for crude oil and condensates.

Comparative assessment

Based on the table below, the proposed royalties are in line with those of Somalia’s neighboring countries.

Royalty	Oil/ oil field	Gas/ gas field
Somalia (proposal)	10%	5%
Kenya	None	None
Mozambique	10%	6%
Tanzania	12.5% for onshore and shelf up to 500m depth 7.5% for deepwater (deeper than 500m)	
Yemen	The rates and thresholds are biddable/negotiable. Rates are not specified for gas. Typical example (oil): 3%: kbopd < 25 5%: 25 < kbopd < 50 6%: 50 < kbopd < 75 8%: 75 < kbopd < 100 10%: kbopd > 100 Additional royalty-like payment of 3% applies to exploration expenditure.	

Biddable or pre-set: Royalties are proposed to be pre-set and not be subject to bids.

Legislative mapping: Royalties need to be included in the petroleum law. The petroleum contract will simply provide reference to the petroleum law.

4. COST RECOVERY

Introduction

Contractors are entitled to recover their costs from oil remaining after royalties (the net production). Many PSAs include terms to limit the total amount of costs which can be recovered from the net production (the so called “Cost Oil”) in any one period (cost recovery limit or “Cost Stop”), or the speed at which such costs can be recovered (recovery rules). The PSA also specify which costs can be recovered, and may include limits with respect to items which are difficult to verify, such as interest or overseas charges for corporate overheads (recoverable costs), or specify whether recovery pools relate to individual fields or to contract blocks (ring fencing).

A cost recovery limit ensures that in each accounting period there is profit production to be shared between a country and an investor. Economically, a cost recovery limit is similar to a royalty (with the difference being the possibility for ultimate recovery of costs later in the project’s lifecycle), and therefore, it should be considered in conjunction with royalty rates. If royalties are moderate or high, a cost limit should not be low, meaning significantly less than 100%.

Further, as in the case with royalties, a low cost recovery limit could discourage the development of high-cost fields. The rate is typically fixed and may be differentiated for oil and gas, as well as for onshore and offshore environments.

In addition to the cost recovery limits, recovery rules should also be considered. Depreciation rules can be incorporated whereby capital costs are not allowed immediately but become recoverable over a specified period of years, or costs could be allowed for immediate recovery subject to a value limit. Recovery rules should be considered in conjunction with the cost recovery limit: if the cost recovery limit is low, stringent depreciation rules could discourage investors.

The costs allowed for cost recovery frequently exclude royalties (as these have already been deducted) and exclude signature bonuses. The PSA accounting rules may restrict the amount of corporate overhead which can be claimed to a fixed percentage of costs incurred, reducing the risk of dispute. The treatment of financing costs varies. If a PSA allows actual financing costs, the project may be financed by high cost long term intercompany debt, thus increasing the cost recovery pool. The amount of financing cost allowed could be restricted by setting a maximum interest rate (e.g., LIBOR plus certain percentage points), or specifying that recoverable costs would include a nominal interest allowance of a fixed rate on the cumulative net cash flow to the contractor parties or, more generously, on the unrecovered cost recovery pool. Allowing interest as a recoverable cost will improve the attractiveness of the project for an investor, but will delay the time when the cost recovery pool is fully recovered, thus keeping the oil available for profit sharing lower.

Ring-fencing rules define the delineation for taxation purposes. While corporate income tax typically applies at company level, in the oil and gas industry a taxable basis could be a contract area or an individual project or field within that contract area. When ring fencing applies at contract area or project (or field) level, income derived from one area/one project cannot be offset against losses from another area/project. Typically, PSAs are ring-fenced to contract area or discovery (exploitation) area.

Recommendation

The Consultant recommends the **cost recovery limit** of 70% of available petroleum (production less royalties), not distinguished for logistical environments (onshore, shallow water, deep water) or hydrocarbons type (natural gas or crude oil).

Further, the more relaxed the **ring fencing rules** are the higher is the incentive for the incremental exploration. The most relaxed ring fencing rules will be at an entity level (meaning that an entity may be engaged in numerous projects in a country). The next level of ring fencing would typically be a contract area. Most stringent rules in PSA environment would be a field level. Cost recovery for Somalia is proposed to be ring fenced to the contract area (rather than to a field).

Within the cost recovery limit of 70%, the proposed **cost recovery rules** include 100% immediate write off for all categories of recoverable expenditure. Recoverable costs include exploration and appraisal costs, development costs, production or operating costs and decommissioning costs. In line with the current Model PSA, loan interest (i.e. financing costs) is proposed to remain non-recoverable and this should be clearly stated in the contract and the accounting procedure as described in the Model PSA. Since the proposed cost recovery approach includes 100% write off within the recovery limit, the order of recovery for different categories of costs does not need to be addressed.

Any unrecovered costs should be carried forward without limitations, subject to the contract's duration.

Overall the accounting procedure as provided in the Model PSA is compliant with best practice in terms of accounting procedure in a PSA environment, but we would recommend inserting additional types of cost in the list of non-recoverable costs (Article 2.7 of the AP - Ineligible costs) as follows:

- ▶ signature bonus; and
- ▶ foreign overhead costs that exceed 1% of total recoverable costs.

Comparative assessment

Based on the comparative assessment below, the recommended cost recovery limit is higher than those of Somalia's benchmark countries. Cost limit should not be assessed on a standalone basis and need to be considered in conjunction with the profit sharing rules, royalties and other fiscal features. We therefore consider the proposed cost recovery rules optimal given the nature of petroleum opportunities in Somalia and Somalia's frontier status.

Cost recovery	Oil/ oil field	Gas/ gas field
Somalia (proposal)	70%. No distinction for oil and gas. Production net of royalty. Any financing costs, signature bonus, and foreign overhead costs in excess 1% of total recoverable costs should be clearly addressed to be non-recoverable.	
Kenya	60%. No distinction for oil and gas. Costs can be recovered in the following order: production costs, exploration costs, development costs, uplift, decommissioning costs. Development costs should be depreciated over 5 years straight line (i.e. 20% each year over 5 years). A 15% uplift is applicable to development costs incurred in first 5 years from the approval of development plan. Interest, arrangement costs and any foreign exchange costs relating to loans or other financing arrangements raised by the contractor for capital expenditure in upstream petroleum operations under the contract are not recoverable. Allocation and recovery of overhead costs should be approved by the tax authorities.	
Mozambique	60%. No distinction for oil and gas. Production net of royalty. Development costs are depreciated over 4 years straight line (i.e. 25% each year over 5 years), other costs are recovered at 100% rate. There is limited information how interest and overhead costs are recovered under PSA.	
Tanzania	50%. No distinction for oil and gas. Production net of royalty. Costs can be recovered in the following order: operating costs, then exploration costs and then development costs. Interest and financial charges are not recoverable. Foreign overhead costs are limited to 1% of total costs.	
Yemen	50%. Not specified for gas. Production net of royalty. Subject to the cost limit: operating costs are recovered without limitation, exploration and development costs are recovered over two years. Interest and bonuses are non-recoverable. Foreign overhead costs are recoverable within the limit of 1%-3% of total recoverable costs.	

Biddable or pre-set: We propose the cost recovery limit be pre-set and not be subject to bids.

Legislative mapping: We propose the cost recovery limit to be included in the petroleum law. The petroleum contract should provide reference to the petroleum law, as well as detail the recovery rules.

5. PROFIT SHARING

Introduction

Sharing of petroleum profit or “Profit Oil” (*i.e.*, the petroleum remaining after the payment of royalty and recovery of the project’s costs, the Cost Oil, (subject to any cost recovery limit)) would usually represent the most significant revenue stream generated by petroleum operations for a country. It would typically also be one of the key fiscal levers that would ultimately determine the outcome of a petroleum regime and a project’s economics.

The basis on which the profit sharing can be determined varies and can be either a flat rate or on a sliding scale. Sliding scales can be based on various factors, such as daily or accumulated production, oil and gas prices, project’s profitability or a combination of factors.

Fiscal features linked to profitability are typically based on a project’s rate of return (e.g., cumulative internal rate of return), or based on a profitability ratio (R-factor). A rate of return measure includes compensation for the time value of money - it will take longer to generate a specific required/target rate of return on a project with a long payback period.

An R-factor is a simpler measure, and represents a ratio of cumulative income to cumulative expenditures. If R equals 1, this would typically mean that cumulative expenditures have been recouped from cumulative income (payback concept); if R equals 2, this would mean that the expenditures have been recouped twice. Although R-factor is generally described as a profitability or Income/Expenditure ratio, R-factors’ formulae vary worldwide. Similar to rate of return (RoR) based measure, an R-factor measure represents the overall profitability of a project and its use contributes to the flexibility of a fiscal regime. An R-factor needs to be carefully designed to avoid adverse consequences for a country, particularly in relation to the threshold limits. The level at which the threshold is set needs to be considered in conjunction with the investors’ required rate of return and the amount of notional or actual interest allowed as recoverable cost.

Recommendation

The Consultant recommends linking the profit sharing to the R-factor sliding scale. While a sliding scale based on a rate of return may be more desirable for investors, as the basis takes into consideration the time value of money, it is somewhat complex to administer from a country’s perspective and particularly vulnerable to costs overruns. As a result, we do not recommend it.

R-factor formula

The proposed formula is the cumulative share of revenue available to the Contractor Group divided by the total project costs which are paid by the Contractor Group:

$$\frac{\text{Cumulative Contractor (Cost Oil + Cost Gas + Profit Oil + Profit Gas)}}{\text{Cumulative Contractor (CAPEX + OPEX)}}$$

This proposed formula is based on the notion that it is a transparent and easy-to-administer production sharing formula. It also helps mitigate any potential controversy surrounding the classification of expenditure as operating expenditure (OPEX) or as capital expenditure (CAPEX) as both form the denominator. The PSA should specify whether the costs are measured on the same basis as costs allowable for cost recovery (e.g., treatment of interest and overheads). It should also specify that the measure of Profit Oil and Profit Gas is the Contractors' share and does not include the public authority's direct share of Profit Oil and Profit Gas. Our recommended formula is based on the Contractor Group meaning it includes both the investor's participating interest and public authority's participating interest (should it opt to participate). It therefore measures overall economics of the Contractor Group and not economics of individual parties to the project (whether private investors or a public authority participating interest).

As an example, if gross revenues in a period were 100 and cumulative costs were 100, the R-factor for the next period would be 0.85:

	\$million		
<u>Project economics</u>			
Revenues	(i) 100		(ii) 100
Costs	(iii) 100		(iv) (100)
Net project cash flows			(v) -
<u>Revenue sharing</u>			
Revenues			(vi) 100
Royalty	(vii) 10%		(viii) (10)
Revenue net of royalty			(ix) 90
Contractor Group Cost recovery	(x) 70%		(xi) (63)
Revenue available for profit sharing			(xii) 27
Public authority share of Profit Oil	(xiii) 20%	(xiv) In first period	(xv) (5)
Contractor Group Profit Oil			(xvi) 22
<u>Memo: cumulative R factor</u>			
Contractor Group Cost Oil			(xvii) 63
Contractor Group Profit Oil			(xviii) 22
Contractor Group cumulative revenue brought forward			(xix) -

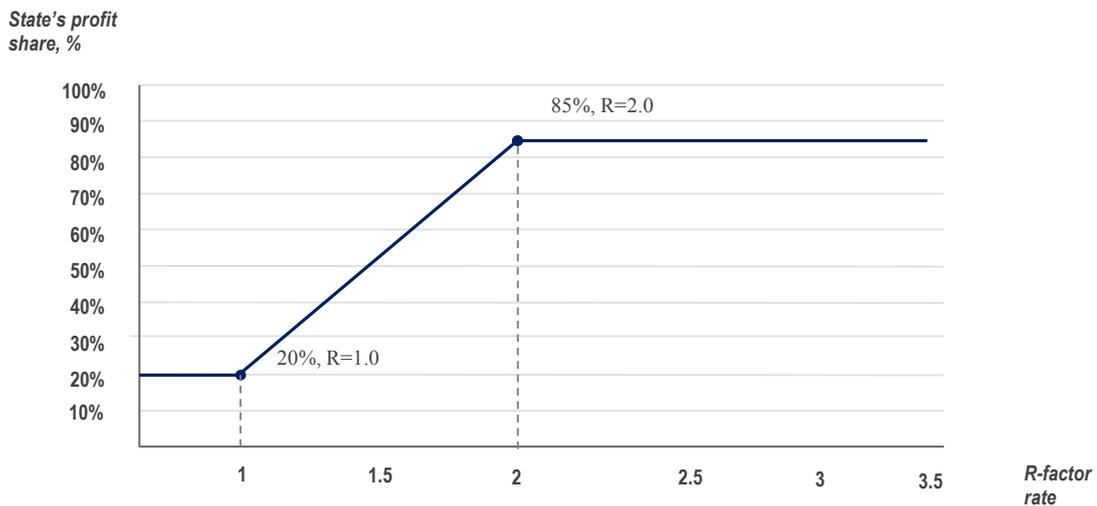
		(xx) 85
Contractor Group cumulative revenue		(xxi) 100
Contractor Group cumulative costs		(xxii) 0.85
R-factor to apply for next period		
		(xxiii) 63
Contractor Group Cost Oil		(xxiv) 22
Contractor Group Profit Oil		(xxv) (100)
Costs		(xxvi) (15)
Contractor Group cash flows before taxes		
	(xxvii) 20%	(xxviii) (3)
Public authority participating interest		(xxix) (12)
Investor share of cash flows		

Threshold structure

Threshold structure is important as it directly contributes to the outcome of the overall R-factor. Ideally, an R-factor should not have tiers that cannot be achieved, but at the same time, should capture any outstanding windfall profits that could occur in the future.

Achieving a tier is an important phase for both an investor and a public authority since the rate of profit share changes as thresholds are crossed, and in some cases, this change could be significant (e.g. a public authority’s share of profit production may double). In light of this, an investor may be motivated to delay progression by inflating investment so as to deter crossing a threshold that will result in profit share changes being subject to a higher rate of tax. Such behavior is referred to as “gold-plating”, whereby the investment in capital equipment may result in tax relief exceeding the original investment, and ultimately leads to non-optimal expenditure levels which in turn affect fiscal calculations.

The main advantage of a linear equation is that tiers are avoided. The main disadvantage of a linear equation is that it may reduce the ability to ‘tailor’ an R-factor to particular characteristics of a field or project. Since both starting point and end point should be defined, defining the points may be difficult. If the end point is too high, for example, when R equals 3 (to ensure the system is able to capture cases when R crosses the rate of 3), the rates will be somewhat low for the R-factor level below 3 (when R never crosses the rate of 3). If the starting point is too low, the rates for small and average fields will be somewhat too high for most expected R-factor ranges, for example, from 1 to 2. A graphical illustration is provided below:



The proposed R-factor structure for Somali share of profit oil and profit gas has the following thresholds as shown on the chart above:

- 20%, for R- factor less than 1.0
- Linear between R-factor of 1.0 (20% rate) and 2.0 (85% rate) (i.e. $20\% + (R-1.0)/(2.0-1.0) * (85\% - 20\%)$)
- 85%, for R-factor of 2.0

Comparative assessment:

The introduction of the R-factor formula in Somalia would be in line with most of the neighboring countries. This profit sharing formula is a good balance between Somalia’s interest and an investor’s one because it links the revenue of the former to the profitability of the latter. Furthermore, such formula is no more complicated to implement than the existing profit sharing formula, which is linked to daily production and price. However, it will require from the competent authority careful collection and audit of revenue and expenditure data.

Profit sharing	Oil/ oil field	Gas/ gas field
Somalia (proposal)	Profit sharing basis: R-factor R-factor, linear. No distinction for oil and gas	
Kenya	Profit sharing basis: R-factor. No distinction for oil/gas and onshore/offshore. State's share: 50%: $R < 1$ 65%: $1 < R < 2.5$ 75%: $R \geq 2.5$ R-factor formula: $\text{Cumulative [Cost petroleum + Profit petroleum - Production costs - Decommissioning costs]} / \text{Cumulative [Exploration costs + Development costs]}$	
Mozambique	Profit sharing basis: R-factor. No distinction for oil/gas and onshore/offshore. State's share: 15%: $R < 1$ 25%: $1 < R < 1.5$ 35%: $1.5 < R < 2$ 50%: $2 < R < 2.5$ 60%: $R \geq 2.5$ R-factor formula: $\text{Cumulative [Concessionaire's Share of profit-petroleum + Concessionaire's Cost Petroleum - Operating Costs]} / \text{Cumulative [Exploration costs + Development costs + production costs]}$	
Tanzania	Profit sharing basis: daily production. Rates are distinguished for oil/gas as well as for onshore/offshore. State's share provided below (the rates for oil have been decreased in the end of 2015 compared to the rates reflected in the Inception report): Oil onshore and shelf (<500m) 50%: $\text{kbopd} < 12.5$ 55%: $12.5 < \text{kbopd} < 25$ 60%: $25 < \text{kbopd} < 50$ 65%: $50 < \text{kbopd} < 100$ 70%: $\text{kbopd} > 100$ Gas onshore and shelf (<500m) 60%: $\text{mmcfd} < 20$ 65%: $20 < \text{mmcfd} < 40$ 70%: $40 < \text{mmcfd} < 60$ 75%: $60 < \text{mmcfd} < 80$ 80%: $\text{mmcfd} > 80$ Oil deepwater (>500m) 50%: $\text{kbopd} < 50$ 55%: $50 < \text{kbopd} < 100$ 60%: $100 < \text{kbopd} < 150$ 65%: $150 < \text{kbopd} < 200$ 70%: $\text{kbopd} > 200$ Gas deepwater (<500m) 60%: $\text{mmcfd} < 150$ 65%: $150 < \text{mmcfd} < 300$ 70%: $300 < \text{mmcfd} < 450$ 75%: $450 < \text{mmcfd} < 600$ 80%: $600 < \text{mmcfd} < 750$ 85%: $\text{mmcfd} > 750$	

	Profit sharing basis: daily production. Rates are biddable/negotiable. Not specified for gas. Example for State's share:
Yemen	70%: kbopd < 25 75%: 25 < kbopd < 50 80%: 50 < kbopd < 75 82%: 75 < kbopd < 100 85%: kbopd > 100

6. CORPORATE INCOME TAX

Introduction

Corporate income tax applies in concession regimes and in some contractual fiscal regimes (in PSAs and service contracts). The impact of a corporate income tax is to reduce the net present value (hereinafter – “NPV”) of a successful project, but, provided that there are no strict depreciation rules (i.e., costs are 100% expensed as incurred), it should not send a positive project into a negative project (neutral effect). However, the impact of a high corporate income tax in the NPV of a successful project may reduce the appetite of an investor to invest in a risky exploration project, where the expected gain must exceed the risk of failure.

The rate of corporate income tax applicable to upstream operations can be the same rate as applied to most other sectors in a country, or can be higher (or significantly higher). If rates are different from the general corporate income tax rate applied to most other sectors in a country, it could be given a specific name, for example, a petroleum income tax.

Alternatively, if the corporate income tax normally applied in a country is not to be levied on petroleum operations (e.g. it is considered to be already included in the petroleum share payable to the public authority), the financial provisions of a petroleum contract should take into account the value resulting from this exemption to a contractor, and the total public authority take should be increased to compensate for the absence of income tax payable.

If the tax is levied on petroleum operations, there should be clear regulations stipulating the income tax provisions, particularly, the income tax base determinations (e.g. taxable revenue, timing of taxation of revenue, allowable cost deduction, depreciation of fixed asset, etc.) including the upstream specific expenditure.

Recommendation

As discussed in the Inception Report, there is currently no legislation in Somalia mandating direct or indirect taxation of individuals or businesses, including corporate income tax, that is applied in practice⁹⁵.

The Consultant recommends that corporate income tax will apply to the petroleum operations, but in a way that may be suitable for Somalia at its current state of general fiscal framework. Instead of being payable directly by the Contractor, the corporate income tax will be factored into the Contractor's share of profit oil and profit gas, with the tax paid from the public authority's share of profit oil and profit gas. That is an approach sometimes referred to as “tax paid” production sharing contracts, and applied, for example in Africa, in Cote d'Ivoire and Gabon. That is because there is currently no comprehensive corporate income tax legislation in place or applied that can be updated to address the specifics of oil and gas operations, and thus

⁹⁵ There is a Decree n°5 dated 5th of November 1966 which partly addresses the direct taxation of business income but we understand this is not applied in practice.

we propose that contractors do not calculate and pay income tax on upstream petroleum operations covered by PSAs in Somalia, but rather receive a profit share net of corporate income tax. Such an approach will also provide certainty for investors against the risk that Somalia could introduce a general corporate income tax, and would contribute to the simplicity of the petroleum regime from an administrative perspective for Somalia.

We propose that corporate income tax provisions are addressed in legislation in order to provide foreign companies with tax credits for their home country income tax calculations, as explained further below.

The proposal to include tax credit certificates arises as stems from certain foreign investors may be subject to worldwide taxation in their home countries. In other words, foreign investors may be obliged to pay tax in their home country on profits arising in Somalia. To avoid excessive overall taxation of the project (*i.e.*, the royalties and profit share payable in Somalia combined with the taxes payable in an investor’s home country on the same profits arising in Somalia, as would be the case in the United States of America) a tax credit would be very welcomed by investors. The petroleum contract would state that corporate income tax is payable on profits, and specify that this tax would be considered paid within the public authority’s share of profit petroleum (“Profit Oil”). It would also specify that the public authority would provide a certificate each year confirming this tax payment.

From a Somalian tax perspective, such an arrangement can be put in place at almost no cost, except for the minor administrative costs related to issuing tax credit certificates. To support the tax credit mechanism, a petroleum income tax law addressing (at a minimum) the tax rate and tax basis will need to be introduced.

We propose the tax rate to be 35% with the tax base being the Profit Oil received by the investor. This computation method will be used to issue the tax credit certificates mentioned above. The petroleum income tax provisions could be included in the petroleum law. We propose that no compliance requirements related to petroleum income tax is included.

Comparative assessment

Based on the comparative assessment below, the proposed corporate income tax structure is different from the peer group. However, we consider the proposed approach reasonable in order to simplify the overall fiscal framework and envisage the basic income tax provision in Somalia.

Corporate income tax	Oil/ oil field	Gas/ gas field
Somalia (proposal)	Contractor is subject to income tax, although the tax is not effectively levied but included into the public authority’s share of profit oil. Tax rate: 35%	
Kenya	Contractor is subject to income tax laws. Tax rate: 30%	
Mozambique	Contractor is subject to income tax laws. Tax rate: 32%	
Tanzania	Contractor is subject to income tax laws. Tax rate: 30% In addition to corporate income tax a contractor pays a net cash flow tax linked to the rate of return. The tax rate is 25% once rate of return of 20% is achieved.	
Yemen	Contractor is subject to tax, but it is paid out of public authority’s share of production meaning no tax is effectively paid by the Contractor.	

Biddable or pre-set: Not applicable

Legislative mapping: The corporate income tax provision, specifically the income tax payable but already included in the public authority’s share of profit petroleum, should be included in the petroleum law. The petroleum contract should provide reference to the petroleum law. Both the petroleum law and the PSA should include the provision related to tax credit certificates and the procedures that investors should follow in order to obtain the tax credit certificates from the competent authority. As for the collection powers, as was explained in this chapter, the recommendation is that no income tax is actually collected since it will be assumed to be included into the share of profit petroleum of the public authority.

7. SIGNATURE BONUS

Introduction

Signature bonuses are commonly used worldwide in both concessional and contractual fiscal regimes. Production bonuses are typically used in PSAs. Bonuses are usually not recoverable in a PSA environment.

Signature bonuses provide up-front revenue for countries, including coverage of costs relating to the organization and execution of a licensing round and license/contact awards. Signature bonuses increase investor’s exploration risks (*i.e.*, increase the cost that will not be recoverable by an investor if no commercial oil and gas is found). In addition, if signature bonuses are high, they may discourage risk-adverse investors.

Production bonuses are payable when specific daily or cumulative production rates are achieved. They are insensitive to a project’s costs and if set high increases the risk of a project and negatively affect a project’s economics, potentially discouraging faster development.

Recommendation

The Consultant recommends including a signature bonus only. Production bonuses are not proposed due to their negative attributes from an investor’s standpoint.

The signature bonus is proposed to be biddable with a pre-set minimum of US\$ 200,000. The signature bonus should be non-recoverable for cost recovery purposes.

We propose the contract awarding criteria to be an incremental work program (in addition to the pre-set minimum work program for each block), and the signature bonus. For bid evaluation purposes, we propose to set the evaluation mark at 25% for the signature bonus, and at 75% for the incremental work program. The greater mark for the incremental work program is explained by the greater need for Somalia to obtain as much geological data and have as many exploration wells drilled as possible. The costs of the incremental work program would be cost recoverable.

Comparative assessment

Based on the comparative assessment below, the recommended bonus structure is moderate; however this does not represent negative consequences for Somalia considering its objective to attract investors. As was explained in this chapter, bonuses (particularly production bonuses) are cost insensitive, if set at high level, and perceived by investors as a distortion. The proposed structure envisages a biddable nature of the signature bonus creating market conditions for blocks awards.

Signature bonus/ Production bonus	Oil/ oil field	Gas/ gas field
--------------------------------------	----------------	----------------

Somalia (proposal)	Signature bonus: Biddable with a pre-set minimum of US\$ 200,000. Production bonus: None.
Kenya	Signature bonus: Biddable/negotiable. Production bonus: None.
Mozambique	Signature bonus: None. Production bonus: Biddable/negotiable.
Tanzania	Signature bonus: US\$ 2,500,000. Production bonus: US\$ 5,000,000.
Yemen	Bonuses are biddable/negotiable. Examples in recent contracts include: Signature bonus: US\$ 1,000,000. Production bonus: US\$ 1,000,000 - US\$ 5,000,000 payable at each milestone daily production threshold. Contracts may also include other types of bonuses or lump-sum payments (institutional bonus, social development bonus, data bank development contribution, research and development contribution) in the range of US\$ 50,000 - US\$ 200,000 each. All bonuses are typically non-recoverable.

Biddable or pre-set: The signature bonus is proposed to be biddable, with a pre-set minimum of US\$ 200,000.

Legislative mapping: Signature bonus, including the biddable nature and the minimum need to be included in the petroleum law. The petroleum contract should provide reference to the petroleum law and should include the final amount of bonus as per the award results (*i.e.*, US\$ 200,000 or higher).

8. SURFACE RENTALS

Introduction

Rentals (also referred to as area fees) are levied based on acreage of a license area or block. Rentals are typically differentiated for each project phase (exploration, development, and production).

The purpose of rentals is to encourage investors to undertake active exploration within a license area or block and to identify areas with higher future prospects and to relinquish those with less future prospects. Revenue streams from rentals can be used by a public authority to cover the costs associated with running an upstream regulator or another competent authority.

Surface rentals are easy to calculate, collect, and monitor, as well as generally insignificant compared to other fiscal features.

Recommendation

The Consultant recommends that the surface rental rates should be set based on the acreage of blocks. The current average block's acreage in Somalia is relatively large. Considering the average acreage, we propose the rental rates to stay the same as they are currently envisaged in the existing Model PSA: US\$10 per square kilometer during the exploration phase and US\$100 per square kilometer during the development and production phase.

Rentals are recommended to be cost-recoverable.

Comparative assessment

Based on the comparative assessment below, the recommended rentals are in line with those of Somalia’s peer countries. The recovery treatment of rentals in the peer group is rather unusual under a broader international perspective. Usually surface rentals are recoverable, therefore we recommend to keep the surface rentals cost-recoverable.

Surface rentals	Oil/ oil field	Gas/ gas field
Somalia (proposal)	US\$10 per square kilometer during the exploration phase and US\$100 per square kilometer during the development and production phase. Cost-recoverable.	
Kenya	Surface rentals are biddable. Typically are at the level of US\$100 per square kilometer for development stage. Surface rentals are non-recoverable	
Mozambique	None	
Tanzania	Initial exploration period - US\$50 per square kilometer. First extension period - US\$100 per square kilometer. Second extension period - US\$200 per square kilometer. Annual license charge for a development license: US\$500 per square kilometer. Surface rentals are non-recoverable.	
Yemen	None	

Biddable or pre-set: The rental levels are proposed to be pre-set and not biddable.

Legislative mapping: Rental rates should be included in the petroleum law. The petroleum contract should provide reference to the petroleum law.

9. TRAINING CONTRIBUTION

Introduction

Typically, the purpose of training fees is to oblige an investor to develop and finance educational programs for Somalia’s nationals with the ultimate purpose of preparing Somali nationals to work in the petroleum industry.

Training fees are typically payable on an annual basis.

Recommendation

The Consultant recommends a training contribution of US\$200,000 annually, with the contribution being recoverable, as envisaged in the current Model PSA.

The training fees should represent the budget for training and educational program(s) and be included in the annual project’s work program or budget of the investor, rather than a payment that is made to a designated country’s institution (See **Section 4.1 of Part 2** above).

The increase in the contribution from the currently envisaged US\$100,000 is explained by the need to cover for the costs of an independent assurance advisor, which Somalia will need to involve to perform the audit of accounts and opine on the correctness of fiscal payments, (including the royalties, cost recovery and sharing of profit petroleum), and also train designated Somalian personnel to undertake such auditing.

Comparative assessment

Based on the comparative assessment below, the recommended level training fee is in line with those of Somalia’s neighboring countries.

Training contribution	Oil/ oil field	Gas/ gas field
Somalia (proposal)	US\$ 200,000 annually. Cost-recoverable.	
Kenya	Biddable/Negotiable. Payable during exploration and development phase. Cost-recoverable.	
Mozambique	Biddable/Negotiable. Annual contributions to the Ministry of Energy training fund.	
Tanzania	US\$500,000 annually. Cost-recoverable.	
Yemen	Biddable/Negotiable. Examples include US\$100,000 annually. Non-cost recoverable.	

Biddable or pre-set: We propose the training fee to be pre-set and not biddable.

Legislative mapping: The minimum budget for training should be included in the petroleum law. The petroleum contract should provide reference to the petroleum law.

10. LOCAL COMMUNITY CONTRIBUTION

Introduction

Various countries are putting in place fiscal features that provide monetary reward or compensation to local communities that are located near the areas where petroleum operations are being conducted as a result of, for example, the ecological footprint of petroleum operations.

The local community payment set in the Model PSA is US\$ 500,000 annually until the start of production, and then is levied at 10%-25% of the Contractor’s profit petroleum, and is cost-recoverable.

Recommendation

The Consultant recommends keeping the local community contribution but switching from a percentage formula to a lump sum mechanism. We would suggest setting it at US\$ 200,000, payable on an annual basis until the start of production, then increasing the annual contribution up to US\$ 500,000.

This payment should be recoverable for cost oil purposes. This local community payment is a modified version of the local community benefit included in the Model PSA, but is set at a much lower level. This payment shall be set under the petroleum law as a contribution to a fund, as mentioned under **Section 4.3 of Part 2** above.

Comparative assessment

Based on the comparative assessment below, we have not identified similar payments to compare. This payment is aimed at addressing the particular federal issue relevant to Somalia, therefore the peer group’s frameworks have little relevance in this respect.

Local community contribution	Oil/ oil field	Gas/ gas field
Somalia (proposal)	US\$200,000 annually until the start of production, US\$500,000 annually thereafter. Cost-recoverable.	
Kenya	We have not identified similar payments which aim is to allocate portion of the rent to local communities.	
Mozambique		

Tanzania	
Yemen	

Biddable or pre-set: The local community payment is proposed to be pre-set and not biddable.

Legislative mapping: We propose the payment be included in the petroleum law. The petroleum contract should provide reference to the petroleum law.

11. GOVERNMENT PARTICIPATION

Introduction

Government participation represents a direct participation of the public authority in a project through a designated public entity (for example, through a national oil and gas company).

Such participation represents an option for the competent entity to join a project within pre-set conditions, including sets the maximum percentage of working interest it can receive, timing during which a public authority can join a project, and the financing basis on which a public authority will be participating in a project.

The participation may be based on one of two major principles:

- ▶ The first is a full equity participation whereby a public authority contributes its share of costs proportionate to its working interest and will receive proportionate share of project's net profits.
- ▶ The second is a carried interest participation, whereby a public authority receives a proportionate share in profits to its working interest, but contributes less than its working interest share of costs. This could take several forms, one of which is when the competent entity's share of costs is paid for by the investors ("carried") through various stages of the project, e.g., such as the exploration, or exploration and development costs. This means that the competent entity will opt to use its option to join the project and will assume it has been a partner from day one of the project, but will not reimburse the investor(s) for its portion of costs incurred prior to the day in which it decides it will use its option to join the project. Other variants require the investors to fund the competent entity's share of costs, but to be able to recover them out of a future share of profit oil payable to the competent entity, possibly with interest.

The timing when a competent entity joins a project could vary and could be at the start of the exploration stage, after a commercial discovery is made, from the start of development, or from the start of production. Investors, however, will required some clarity as for the timeline a competent entity can join a project, e.g., a competent entity can opt within 2 or 6 months after a commercial discovery is made or once a development plan is approved. Investors may consider any form of direct national participation as a distortive factor since it may affect the decision-making process and optimal project execution. Investors may consider carried participation to be a particularly distortive factor since there would be an additional cost for the investor which may significantly affect the investor's returns.

Carried public authority participation should be carefully assessed by countries as a carried interest is a particularly distortive factor for investors, while full equity participation needs to be reconciled with the competent entity's financial ability to pay its share of costs.

The important positive aspect for a public direct participation in a project is the learning experience for the designated competent entity of running a project and managing petroleum operations.

Recommendation

The Consultant recommends retaining the option for Somalia for direct participation in projects, through a single competent entity. However, we propose that the maximum interest that such competent authority may have is set to 25%. We also particularly stress that although the option for a public direct participation is retained, we recommend that the competent entity does not execute its right due to financial obligations that it would impose on such competent entity (and apparently on Somalia), and other considerations, such as insufficient capacity of the competent entity, potential for political interference and possible costly delays on the part of the competent entity in meeting cash calls which will have negative impact on investors.

The competent entity will be required to join the Association Contract, as member of the Contractor.

We propose that the competent entity be granted the ability to utilize its option within 6 months from the approval of a development plan. As for the financial basis, we propose that the competent entity’s interest is carried through exploration (in other words, Somalia would not reimburse investor(s) for its percentage of exploration costs), and becomes full equity interest thereafter (in other words, Somalia will contribute 100% of its share of costs after the exploration phase is completed). Since Somalia would most likely join a project only after a commercial discovery is made (if any), it would seem reasonable from an investor’s perspective that Somalia would need to contribute to any post-exploration costs. It is important to note that the development phase would be the most capital-intensive phase of a project since the majority of production and drilling of injection wells will be done to ramp up the hydrocarbons production.

It is still advisable that Somalia carefully considers the percentage it would opt for (within the 25%) based on its financial abilities at the time such a decision would need to be made, to avoid any controversy with investors.

A requirement to pay for or fund a competent entity’s share of development or other costs and thus make a disproportionate contribution to post-exploration costs would be considered by investors as a significant deterring factor which could significantly reduce an investor’s interest in the blocks or may lead to the reassessment and redesign of other fiscal features.

Comparative assessment

Based on the comparative assessment below, the recommended maximum participation percentage is in line with the peer group.

Government participation	Oil/ oil field	Gas/ gas field
Somalia (proposal)	Maximum participation share of 25%. Exploration costs, including appraisal, are not reimbursed.	
Kenya	Biddable/negotiable. Participation starting development stage. Exploration costs are not reimbursed.	
Mozambique	Biddable/negotiable. Carried through exploration stage but repayable with interest later. Interest in the 5 th licensing round was 10%, 15%, 20% and 30%.	
Tanzania	Minimum 25% at any time. Exploration costs, including appraisal, are not reimbursed.	
Yemen	Biddable/negotiable. The carried interest is in the range of 5% to 25% and the carried costs may or may not be repaid.	

Biddable or pre-set: The maximum participation percentage is proposed to be pre-set in the petroleum law and not biddable. The particular percentage within the maximum of 25% would be at the discretion of the competent entity.

Legislative mapping: The payment instructions should be included in the petroleum law. The petroleum contract should provide reference to the petroleum law.

12. OTHER TAX MATTERS

12.1 Taxation of capital gains

Introduction

Taxation of capital gains is particularly relevant to the petroleum industry since gains (if any) are emanating from minerals which are expected to be taxed should they be owned by a nation (which is typically the case).

A capital gain may arise once a participating interest in a project is sold to another company, for example, an existing investor(s) wants to sell all or part of its interest in a project to a third party. The difference between a sale price and historical costs of such interest will form the capital gain, should the difference be positive.

Depending on the project's phase and the amount of interest that is being sold, the sale price will vary. For example, the sale price can encompass the full amount corresponding to the market price of the interest sold (typically once an investor sells all of its interest and will no longer participate in that project). Alternatively, if an investor sells only a portion of its interest in a project, the sale price can be structured in a different way: a seller could receive some remuneration in cash, and the remainder will be paid by a buyer through a disproportionate contribution to on-going projects costs, effectively paying for some of the on-going costs that the seller itself would need to pay (e.g., a buyer will acquire 10% interest in a project, but will contribute to all or some of the on-going costs as if it had acquired 15% interest). This kind of partial sale can accelerate developments by bringing in certainty on funding.

Interest can also be sold directly or indirectly. A direct sale of interest means the buyer acquires interest in an entity or in an incorporated joint venture in a country where the petroleum operations are undertaken. An indirect sale would be the sale of the same interest at a level of an intermediate or a project holding company outside the country where the petroleum operations are undertaken.

An indirect transfer can be chosen for either tax and/or non-tax purposes. Tax purposes may include tax structuring in order to put a transaction and therefore a capital gain (if any) outside a scope of capital gains taxation rules applicable in a country where an underlying project is located. In addition, there are a number of other valid business reasons that could drive an indirect transfer of interest, for example, the need to structure a transaction under a foreign law, to be able to enforce various internationally used mechanisms applied in merger and acquisition deals (for example, irrecoverable power of attorneys, representations and indemnities, etc.) which simply cannot be enforced if a deal is structured under a local law that does not recognize foreign law provisions.

Taxation of capital gains can be in the following ways:

- ▶ Flat rate tax: A fixed tax is levied on the total price of the assignment; or

- ▶ Real tax: A tax is levied on the capital gain. The main concern here relates to how the capital gain is calculated by the assignor. Indeed such calculation supposes the determination of the sale price and of the initial value of the participating interests:
- ▶ The sale price may not always easily be calculable at the point of transfer, especially where the price includes:
 - All or part of the future petroleum costs related to the participating interest of the assignor which may not be known at the point of transfer; and/or
 - Sums payable at various stages that cannot be predetermined (such as, in the event of a commercial discovery, the commencement of hydrocarbon production or at the point where predetermined levels of production are met).

Calculating the initial value of the participating interests to be transferred may also be difficult at the point of transfer, especially where the assignor is the only holder of such interests.

Sometimes, a transfer of interest may occur from one company to another within the same group due to a need for an intercompany reorganization caused by various reasons and the level of a group's head office (for example, a merger with another international company, migration of holding companies from one jurisdiction to another, etc.). For capital gain purposes, such internal transfers are still need to be monitored by a public authority, however, if it is proved that a transfer is pure internal and no controls is ultimately transferred to a third party, such gain should not be taxed. Some countries still imply taxation in such situations, since they believe intracompany transfers should not happen in a normal course of business, and also want to prevent any intracompany transfers that can be used in some sophisticated ways to execute an indirect transfer to a third party.

Recommendation

The Consultant recommends that Somalia opts to tax capital gains arising from transactions where the value is derived by its natural resources, whether through a direct or indirect transfer of interest. The recommendation is to target only those capital gains which will result from cash payments.

We propose the capital gains tax rate to be 20% on the difference between a sale price and a purchase price (i.e. historical costs).

The liability for the payment of the capital gain (if any) should be generally on the seller. However, we also recommend introducing joint liability for a buyer, in case a seller fails to pay the capital gain due. Joint liability creates a strong incentive for the seller to carefully assess such an exposure and seek contractual protection from a seller, which in practice increases the overall discipline for the capital gain liability by companies.

As outlined in **Section 1.3.2** of **Part 2** above, in order for the public authority to identify that a transfer of interest has occurred, including intercompany reorganizations, we propose that change of controls procedures are implemented to monitor any change of control, and thus any transfers of interest.

However, any transfer of interest within the same group (without any effective change in control, whereby an oil and gas company transfer or splits its interest in a project from one entity in its corporate group to another) should be considered exempt from capital gains taxation.

We recommend calculating the capital gain as the difference between the petroleum costs (recoverable and non-recoverable) incurred by the assignor and the total acquisition price

(immediate proceeds only, without future component such as disproportionate contribution to the project) to be paid by the assignee. In case of farm outs where a farmor sells part of its interest in a project for a disproportionate contribution to projects costs by a farmee, such transaction should not be in scope for the capital gain tax. This method could be considered as most reasonable as it helps avoid a potentially difficult discussion over the transfer price and calculation of initial value.

We recommend introducing an annual filing template to report capital gains to emphasize the existence of capital gain taxation and companies' awareness. We recommend that in case of absence of taxable events for capital gain purposes, a nil return is still filed by a company to emphasize the responsibility of companies' officers and maintain tax discipline.

Comparative assessment

Based on the comparative assessment below, the proposed capital gains tax is in line with the capital gains tax imposed by Somalia's neighboring countries.

Capital gains tax	Oil/ oil field	Gas/ gas field
Somalia (proposal)	Both direct and indirect sales are captured. Tax rate: 20%, applicable to the difference between the petroleum costs (recoverable and non-recoverable) incurred by the assignor and the total acquisition price (immediate and future) to be paid by the assignee. Joint liability of the seller and the buyer for the payment of the tax.	
Kenya	Both direct and indirect sales are captured. Interest's value should be directly or indirectly derived by 20% or more of from an interest in a petroleum agreement. The taxable basis is the net gain from interest's disposal. The net gain is computed as the consideration for the disposal reduced by the cost of the interest, according to formula: $A*B/C$ where: "A" is the net gain; "B" is the value of interest derived directly or indirectly from an interest in petroleum agreement in Kenya; and "C" is the total value of the interest. The rate is 20% for non-residents and 10% for residents. A licensee or contractor is required to notify the Commissioner immediately in case of change in the underlying ownership of a licensee or contractor of 10% or more. Where the interest is disposed by a nonresident, the licensee or contractor shall be liable, as the tax agent of the nonresident person, for tax payable as a result of the disposal.	
Mozambique	Both direct and indirect sales are captured. The rate is 32%. Nonresidents must appoint a tax representative in Mozambique to comply with their tax obligations. The purchaser or the holder of the petroleum rights has joint and several liability for the payment of the tax in case the seller is a nonresident entity without permanent establishment in Mozambique. In the case of resident taxpayers, the gain is included in the taxable income of the respective financial year and is taxed at a general rate of 32%.	
Tanzania	Both direct and indirect sales are captured. Where the underlying ownership of an entity changes by more than 50% as compared with the ownership at any time during the previous two years, the entity is treated as realizing any assets owned and any liabilities owed by it immediately before the change. Intercompany reorganizations are not exempt.	
Yemen	The rate is 30%. Additional stamp duty applies. Both direct and indirect sales are captured. The rate is 15%.	

Biddable or pre-set: Not applicable.

Legislative mapping: The provisions stipulating the taxation of capital gains should be addressed along with the petroleum income tax provisions (whether in the petroleum law or in the petroleum income tax law (in the case where it is a separate document to the petroleum law)). The petroleum contract should provide reference to the relevant provision in the applicable law.

12.2 Customs duties

Introduction

Oil and gas equipment, especially for offshore operations is very expensive. Import customs duties, even if introduced at moderate rates represent a significant cost for upstream operations and particularity impact the exploration and development phase due to the high-cost equipment required for such operations.

Export duties for petroleum products are similar in nature to royalties and are applied by a very limited number of countries in the world.

Import duties, if applied, are payable from the very early stage in the project before any revenue is generated, since the exploration and the development phase (when the majority of wells will need to be drilled and massive construction of facilities and infrastructure will take place) occur prior to production. The equipment that is used in the upstream activities is extremely expensive and thus any duties will impose a significant fiscal burden on investors early in the project life, as well as increasing recoverable costs and decreasing government profit share.

The economic purpose of export duty is to regulate outbound trade, by either promoting exports of certain goods (e.g., by setting zero export duty) or restricting exports of certain goods (by charging significant or very high duty rate). If export duties apply for crude oil and gas (and broadly for minerals), they effectively serve as a gross royalty, with the drawbacks of royalties (mainly that this is a cost-insensitive fiscal feature) since they reduce the value of production available for cost recovery or profit share.

Recommendation

The Consultant recommends exempting petroleum operations from customs duties, both from import and export duties and payments. This is generally in line with international practices applied to upstream projects by many countries.

The recommendation is to provide the exemption throughout the project's life both from import and export duties and payments for fiscal stability and predictability purposes. From the revenue stream perspective for Somalia, revenue will be generated from other fiscal features, should there be commercial discoveries in Somalia.

Comparative assessment

Based on the comparative assessment below, the recommended approach is in line with those of Somalia’s neighboring countries. The recommendation for full exemption for Somalia is explained as it will be easier to administer.

Customs duties	Oil/ oil field	Gas/ gas field
Somalia (proposal)	Exemption.	
Kenya	Exemption.	
Mozambique	Exemption or a period of five years from the date a development plan is approved.	
Tanzania	Exemption.	
Yemen	Exemption.	

Biddable or pre-set: Not applicable.

Legislative mapping: The customs duties exemption provisions should be addressed in the petroleum law. The petroleum contract should provide reference to the petroleum law.

12.3 Taxation of foreign subcontractors

Introduction

Petroleum service companies (further referred to as “subcontractors”) are an essential part of the petroleum industry and provide technology and services to exploration and production companies.

Service companies worldwide apply a pricing mechanism whereby they receive their service fee net of any taxes that may be applicable in the country where the investor is operating (for example, withholding taxes). If withholding taxes apply, this results in increased costs for the exploration and production company, and in turn increase the project’s overall costs, which ultimately are recovered.

Recommendation

The considerations for taxing subcontractors in Somalia are challenging. Due to the absence of established petroleum industry in Somalia, and lack of local oil field service companies, contractors will need to involve foreign subcontractors which will account for almost all of the project’s capital expenditures. Clearly sub-contractors will be receiving revenue emanating from Somalia which are expected to be taxed in Somalia. On the other hand, subcontractors also have gross up clauses on their contracts to ensure that no withholding taxes (as may be applicable) reduce their remuneration for a service or equipment. If a withholding tax will apply in Somalia, (say a 10% tax), that will effectively mean that project’s costs will become more expensive by 10% since the withholding tax will need to be compensated by contractor at its own costs. Therefore, taxing subcontractors at this stage of sector in Somalia is a challenging policy issue.

As for the local subcontractor, due to the absence of corporate income tax in Somalia, it seems reasonable to introduce a withholding tax, which will be withheld by a Contractor.

The Consultant recommends that a withholding tax is introduced at moderate levels with separate rates for foreign and local subcontractors. The taxable basis for the withholding tax is proposed to be the gross remittance payable to the subcontractor, which is generally in line with international practice. The rate for foreign subcontractors is recommended to be set at 5%, and at 3% for local subcontractors with reasonable substance in Somalia (for example, set up a

warehouse and bring its technical and administrative specialists on-shore) to create an incentive for service companies to set up a legal presence in-country.

For local subcontractors, the tax withheld by the Contractor should be eligible as a tax credit against their corporate income tax liability in Somalia. For example, a local subcontractor will supply services worth \$100 to a Contractor and the latter will withhold tax of \$3. A local subcontractor will be liable to the general corporate tax regime in Somalia and once it will determine its tax due, such tax due will be reduced by the \$3 tax withheld earlier.

Comparative assessment

Based on the comparative assessment below, the recommended approach is in line with those of Somalia’s neighboring countries. The proposed tax rates for Somalia may be considered lower than in the benchmark countries, but the frontier status of Somalia needs to be taken into consideration to reduce distortions for potential investors for the first licensing round. .

Taxation of foreign subcontractors	Oil/ oil field	Gas/ gas field
Somalia (proposal)	5% withholding tax for non-resident and 3% for local providers.	
Kenya	Effective 1 January 2016, withholding tax on fees paid to a non-resident subcontractor in respect of services relating to petroleum operations reduced from 20% to 5.625%.	
Mozambique	10% withholding tax.	
Tanzania	Payments to non-residents for services related with the petroleum activity are subject to withholding tax at the rate of 15%. A 5% rate applies to resident providers.	
Yemen	There is an exemption in the contract from income taxes for subcontractors, except for the 3% tax during exploration phase, but overall there is limited information on this matter, including the applicability of the 3% tax to subcontractors.	

Biddable or pre-set: Not applicable.

Legislative mapping: Provisions for the tax exemption granted to foreign service providers should be addressed in the petroleum law. The petroleum contract should provide reference to the petroleum law.

12.4 Withholding tax on dividends and loans

Introduction

Withholding tax on dividends and loans are applied by most countries and are part of a company’s corporate or business tax regime. The purpose of withholding tax is to tax income of foreign recipients that do not have a taxable presence in a country from which they derived the income. Withholding tax typically target passive types of income, such as interest, rent income, dividends, and royalty for the use of trademarks or know-how.

Recipients of income typically gross up the payment amount to cover any withholding tax that may be applicable in the payer’s country, so such withholding taxes consequently represent an additional cost for the payer who will be bearing the cost of the withholding tax.

Recommendation

The financing of upstream projects will be coming mostly from intragroup companies, therefore, the Consultant recommends an exemption on withholding tax applied to loan interest, since the interest is not cost recoverable and the contractor will not take advantages of any tax deductions. From revenue stream perspective for Somalia, revenue will be obtained from other fiscal features, should there be commercial hydrocarbon discoveries in Somalia. Once Somalia will have an established general corporate income tax framework, applicable to all industries, a withholding tax may be introduced to target third party financing.

As for the dividends a 10% withholding tax rate may be considered.

Comparative assessment

Based on the comparative assessment below, the recommended approach differs from the peer group. The recommendation for full exemption for Somalia is explained by easier administration and the need to remove distortion for operators for the first licensing round, since the tax on loans will effectively increase operator costs. The exemption of dividends could create an incentive to finance the project through equity rather than loans.

Withholding tax on dividends and loans	Oil/ oil field	Gas/ gas field
Somalia (proposal)	Dividends: 10%. Loans: exemption	
Kenya	Dividends: 10%. Loans: 15%.	
Mozambique	Dividends: 20%. Loans: 20%.	
Tanzania	Dividends: 5% or 10%. Loans: 10%.	
Yemen	Dividends: 10%. Loans: 0% or 10%.	

Biddable or pre-set: Not applicable.

Legislative mapping: The provisions of the exemption should be addressed in the petroleum law. The petroleum contract should provide reference to the petroleum law.

12.5 Personal income tax and social payments

Introduction

Social security contributions are typically levied by public authorities to finance social security of those nationals or permanent residents who will benefit from such a national healthcare/pension system. Expatriates working in a country, even on long-term assignments, typically do not benefit from such healthcare/pension systems unless they decide to permanently reside in that country.

Personal income taxes on the other hand are typically levied on employee’s income to provide an ordinary revenue stream for governments, similar to the taxation of businesses.

Social security contributions and personal income tax are usually composed of contributions paid by the employer and the ones paid by the employee.

Recommendation

There is a relevant legislation in place in Somalia governing taxation of individuals⁹⁶, although the legislation might not be currently fully implemented and applied in practice.

Taxes payable by employees (whether directly or withheld by an employer)

The Consultant recommends that both foreign and local employees remain subject to personal income tax and social security contributions, as may be applicable under existing Somalian legislation.

We also recommend that companies remain liable to withhold and remit the applicable taxes as required.

Taxes payable by employer

We recommend that no contributions are payable by employers in respect of the personal income tax and social security contributions of its foreign employees while such contributions are still due by the employer for local employees. From the revenue stream perspective for Somalia, revenue will be obtained from other fiscal features, should there be commercial hydrocarbon discoveries in Somalia.

Comparative assessment

Based on the comparative assessment below, the recommended approach differs from the peer group. Considering the absence relevant legislation in place in Somalia, the recommended approach will be easier from an administration management perspective.

Personal income tax/ social payments	Oil/ oil field	Gas/ gas field
Somalia (proposal)	Employees: under existing applicable tax legislation. Employer: Exemption for foreign employees but taxation for local employees.	
Kenya	Personal income tax: 10%-30%. Social payments: KES 200 per month.	
Mozambique	Personal income tax: 32%. Social payments: 7%. Non-residents are taxable only on their Mozambican source income at 20%.	
Tanzania	Personal income tax: 12%-30%. Social payments: 20%.	
Yemen	Full exemption during exploration.	

Biddable or pre-set: Not applicable.

Legislative mapping: The provisions stipulating the exemption should be addressed in the petroleum law. The petroleum contract should provide reference to the petroleum law.

12.6 Other taxes and payments

There is legislation in place in Somalia which envisages such taxes and levies as excise tax, stamp tax, customs duties, and others, although such legislation might not be currently fully implemented in practice.

Considering the objectives of the fiscal framework for petroleum operations in Somalia, we propose to exempt petroleum operations from any other taxes, levies or payments in any form

⁹⁶ Decree n°5 dated 5th of November 1966.

other than those listed in the petroleum law and the petroleum contract (and recommended above). This is essential to provide investors with a clear picture of the fiscal burden they should expect when undertaking petroleum operations in Somalia.

Offering such clarity and stability in the applicable fiscal terms is important for investors, especially when taking into consideration that the regulatory environment in Somalia is still evolving. Please also refer to the recommendation and discussion of the stability provisions addressed in **Section 4.1 of Part 3** above.

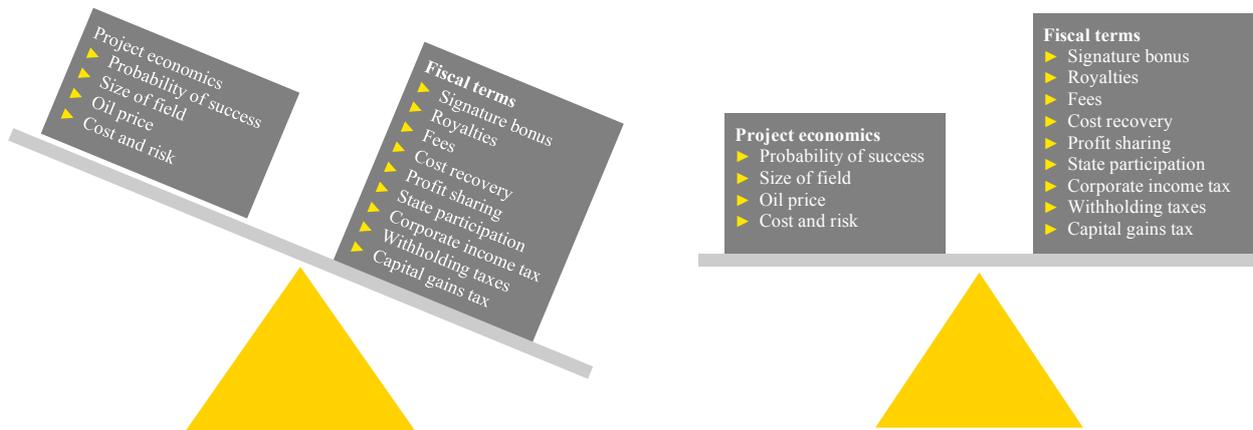
It is important to emphasize that it will be possible for Somalia to modify its overall approach to taxation of the petroleum operations in the future, should commercial discoveries of hydrocarbons and further opportunities to explore oil and gas in Somalia arise. Somalia should ensure that the fiscal terms offered to investors during the first licensing round are respected and honored.

13. COMPARATIVE ASSESSMENT OF THE PROPOSED FISCAL REGIME

Approach to modeling

Investor perspective

When deciding how to invest, an investor will consider many factors, including the attractiveness of the fiscal terms, the security and stability of the environment, and the economics of the proposed project. A fiscal regime should be competitive with equivalent other countries, but it may need to be adjusted to allow for these other factors. This is particularly the case for a frontier country, where there is no long track record of successful exploration, and the risks to an investor are higher. In this case, the “weight” of the fiscal terms may need to be less than for more established countries in order to make it attractive to investors.



Probability of success and expected value

An investor needs to take into account not just the benefits of a successful project, but the potential cost of unsuccessful exploration. As an example, if exploration costs are US\$ 100 million, and there is a 33% chance of success, then an investor would need the success case to generate US\$ 300 million net present value simply in order to compensate for the risk of failure and the costs of exploration. Signature bonus is similar to exploration costs, as it is payable at the start of a contract, before the success or otherwise of the contract area is known.

	Probability	Outcome	Exploration cost	Net	Expected value
Success	33%	300	(100)	200	67
Failure	67%	-	(100)	(100)	(67)

Total 100%

Example fields and modeling results

The project economics will depend on the size and characteristics of the potential hydrocarbons. There is no such thing as a typical field, and projects vary in their size, their production decline patterns, and the balance of capital and operating costs. Generally offshore fields are more expensive to explore and develop, with onshore developments having lower capital costs. For the purposes of comparison, we have looked at illustrative fields with recoverable reserves of 50 million boe, 100 million boe or 500 million boe at a long term price of \$80/boe, consistent with that used in our inception report. The illustrative project does not represent potential oil developments in Somalia, but is used to test the proposed fiscal regime. We have as well tested the assumed fields under \$45/boe as a low price scenario, and under \$100/boe as a high price scenario. We have used unified field assumptions (production and costs) for Somalia, as well as for the peer group countries. It will be strongly advisable to discuss the expected potential oil and gas developments in Somalia during the workshop following this Provisional Report in order to fine tune the proposed fiscal terms based on expected costs assumptions, as the case may be. The currently proposed fiscal framework is designed in a way that it could be further adjusted to accommodate more the marginal fields, e.g. by lowering the royalties, increasing the cost recovery limit.

To analyze the modelling results we have provided the government take ratio and the project’s internal rate of return (hereinafter – “IRR”). Should the costs assumptions or assumed field’s size change, the government take figures and IRR will change as well.

The government take is provided on both undiscounted basis (GT0) and discounted at 10% (GT10). The government take measures how much of the net project’s revenue accounts for the payments to a country over a project’s life. The payments to a country are compared with a net project’s revenue (gross revenue less capital and operating costs) rather than gross revenue. That based on the rational concept that investors need to recover the project’s costs, and what is left after the recoupment of costs is what could be further split between an investor and a country. If a government take were more than 100%, this would mean that a country has taken out more than the net project’s revenue. That could typically happen because of excessive royalties or other cost-insensitive fiscal features that are payable before an investor recovers its costs, as well as because of a combination of high royalties and tough split of profit sharing.

Government take is an important indicator since countries are competing with each other for investments, both international and in-country. In this sense, this is a convenient indicator to compare the relative competitiveness of one fiscal regime against another. The government take can be determined at various discount rates and will vary with oil price, field size, capital expenditures and operating expenditures. The government take itself however does not provide a comprehensive assessment of an overall attractiveness of a fiscal regime (as long as it is below 100%). For example, a government take of 80% does not necessarily mean a project would have satisfactory economic yardsticks. The economic yardsticks which are important for the making of investment decisions (e.g. internal rate of return, profitability ratios, project’s net present value) are directly affected by the timing of project revenues and government take.

A project’s post-tax/take IRR is a relatively practical measurement of project’s economics from investor’s standpoint. However, it should always need to be considered in conjunction with other economic yardsticks, such as net present value and others. A minimal acceptable IRR may significantly vary for companies, depending on their strategies and profile. An average minimal

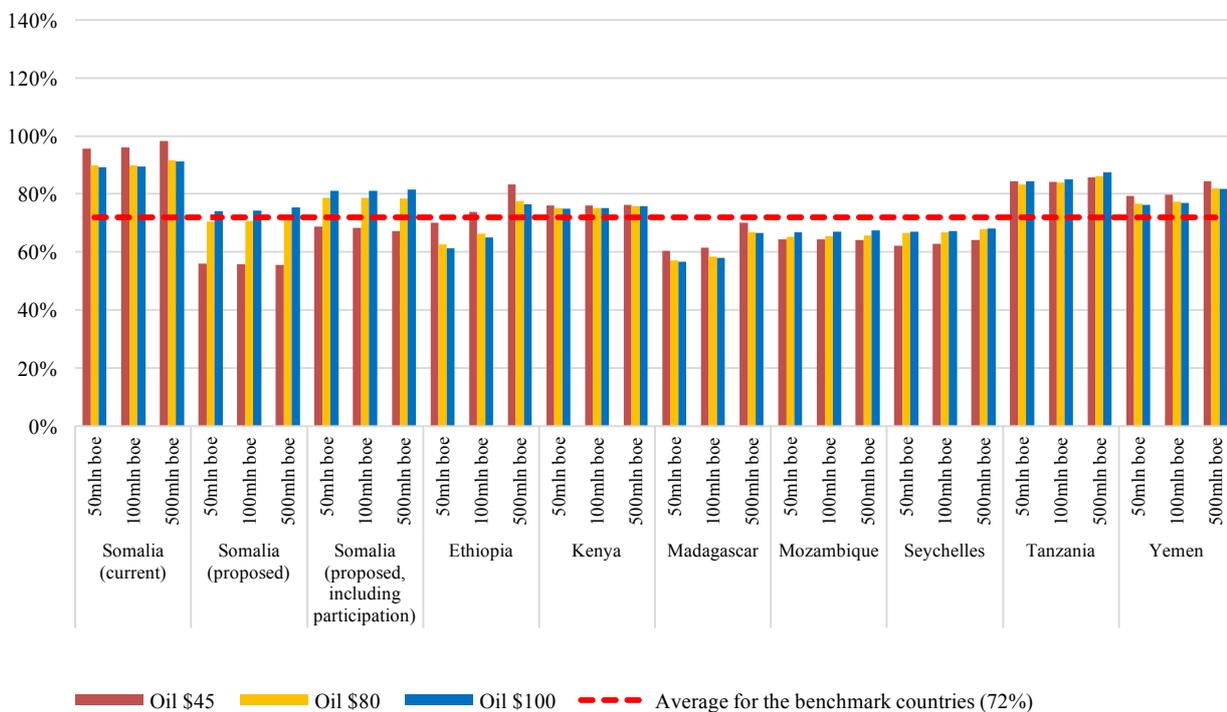
acceptable IRR in the industry may be considered an IRR in the range of 15% to 20%. The proposed fiscal framework (both participation options) delivers a competitive IRR, including under low oil price scenario.

The proposed fiscal framework is competitive under low, medium and high oil price scenarios, compared to the peer countries, mainly Mozambique, Tanzania and Kenya as the countries which have most active developments in their petroleum sectors. It is also important to note that the proposed framework is progressive and also able to adjust to low oil prices which is very important for investors. The proposed framework is significantly more competitive than the current framework.

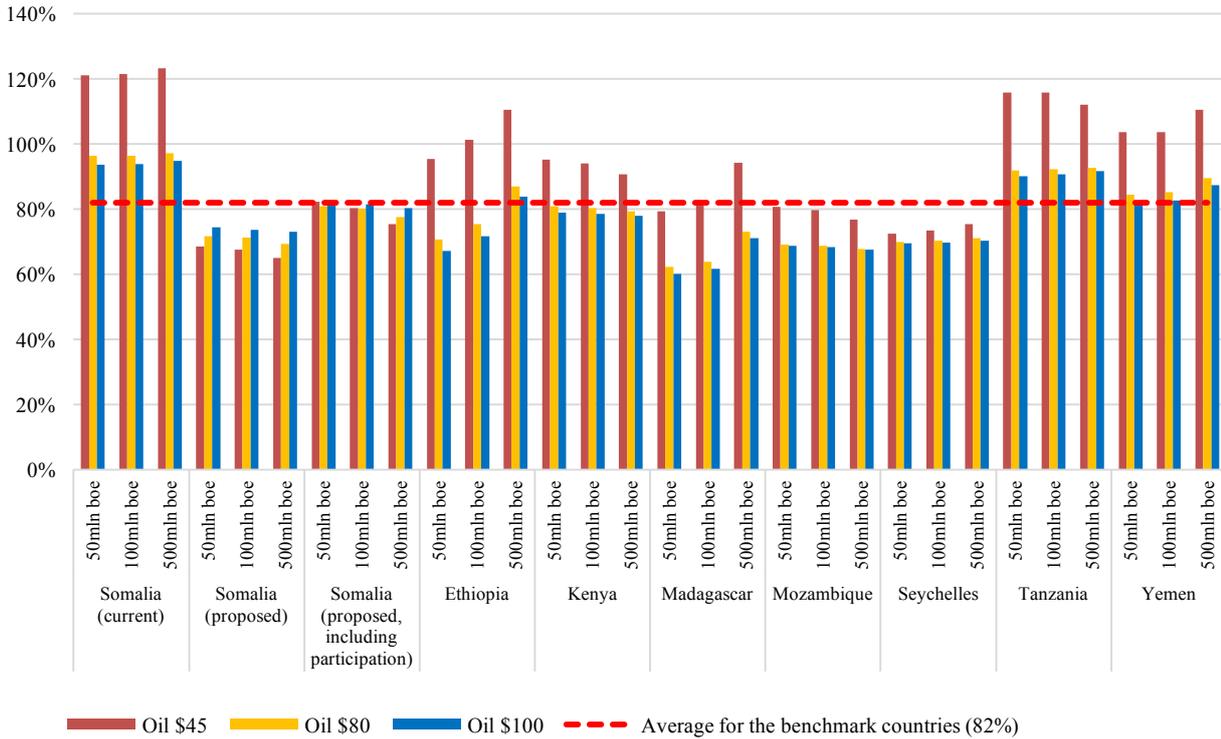
The difference between the “Somalia (proposed)” and “Somalia (proposed, including participation)” is that we have assumed zero and 25% participation of the competent entity in the project respectively, based on the terms according to Section 11 of this Part 4 of the Report.

Below we provide the government take and IRR data for Somalia under three field cases.

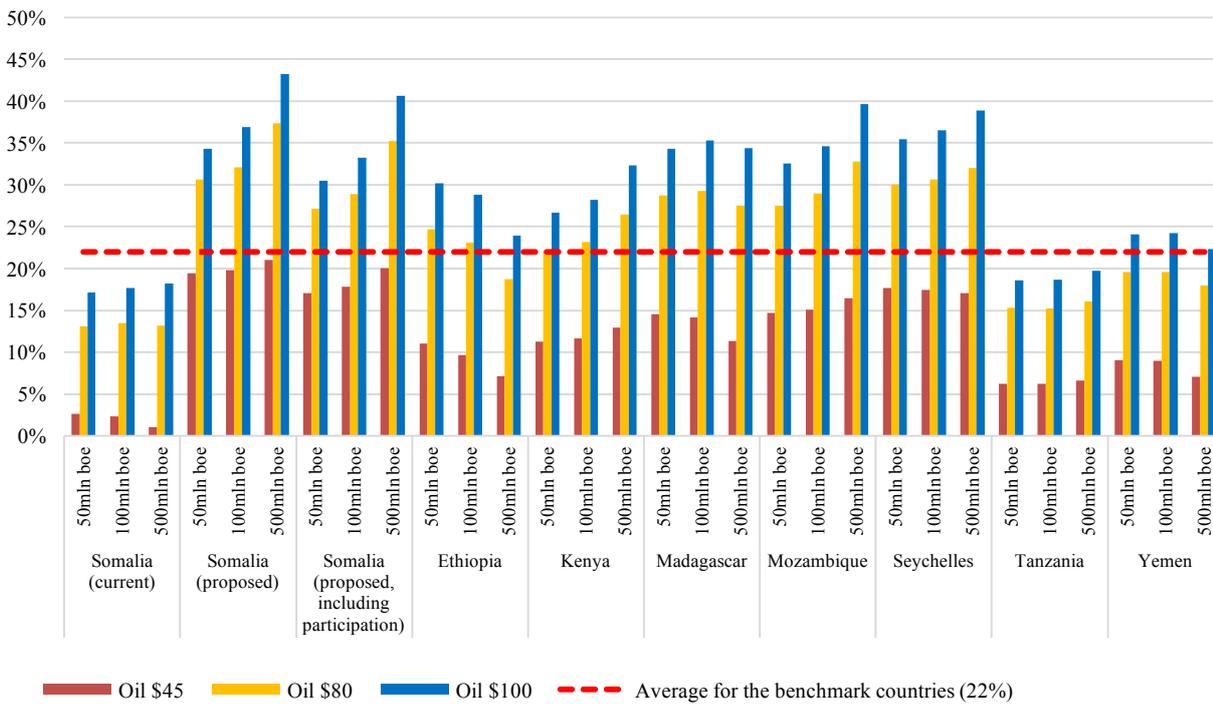
Government take (undiscounted)



Government take (10% discounted)



Contractor's After Take IRR



Schedule 1 - List of reviewed documents

- 1- Provisional Constitution of the Republic of Somalia dated 1st August 2012;
- 2- Transitional Federal Charter of the Somali Republic dated February 2004 (Nairobi);
- 3- Petroleum law of Somalia n° XGB/712/08 dated 6 August 2008;
- 4- Somalia model PSA dated 30 January 2007 (Barrows);
- 5- Constitution of Somaliland approved on 31 May 2001;
- 6- Mining code of Somaliland dated April 2000;
- 7- Federal Government's petroleum strategy dated May 2014;
- 8- SOMA Oil & Gas presentation "Unlocking Somalia's Potential - 1st International Forum on Somalia Oil, Gas & Mining (27-28 April 2015, London, UK);
- 9- Somali map for graticulation of the petroleum domain on the Minister of Petroleum Website - January 2015 (Schedule 2);
- 10- Draft Terms of References for the review of the policy and strategy framework of Somalia for the petroleum sector - no date;
- 11- A rejected proposal for indicative fiscal terms for offshore PSAs - no date;
- 12- Concession agreement for the exploration and mining of hydrocarbons in Blocks M-3, M-4, M-5, M-6 and M-7 between the Government of the Somali Democratic Republic and Pecten Somalia Company dated 1st November 1988.

Schedule 2 - Agenda and list of participants of the kick-off meeting in Nairobi on 10th and 11th November 2015

1- Agenda

Venue: The World Bank office in Nairobi

Hill Park Towers, P. O. Box 30577 Upper Hill Rd, Nairobi, Kenya

Tel: +254 20 3226000

Day 1: 9:00 - 16:00

Morning 9:00 - 10:00:	Introduction / Briefing on the Somali process
10:00- 12:30	Legal presentation by Gide / discussions
12:30 - 13:30	Lunch break
Afternoon 13:30 - 16:00	Economic and fiscal presentation by EY

Day 2: 9:00 - 16:00

Morning 9:00 - 12:30	Review of the current situation in Somalia
12:30 - 13:30	Lunch break
Afternoon 13:30 - 16:00	Discussion on the next steps.

2- List of Participants

Consultant

- François Krotoff, Gide Paris;
- Alix Deffrennes, Gide Paris;
- Emma Cotton, EY London; and
- Mathieu Calame, EY Côte d'Ivoire.

Somali Federal Republic

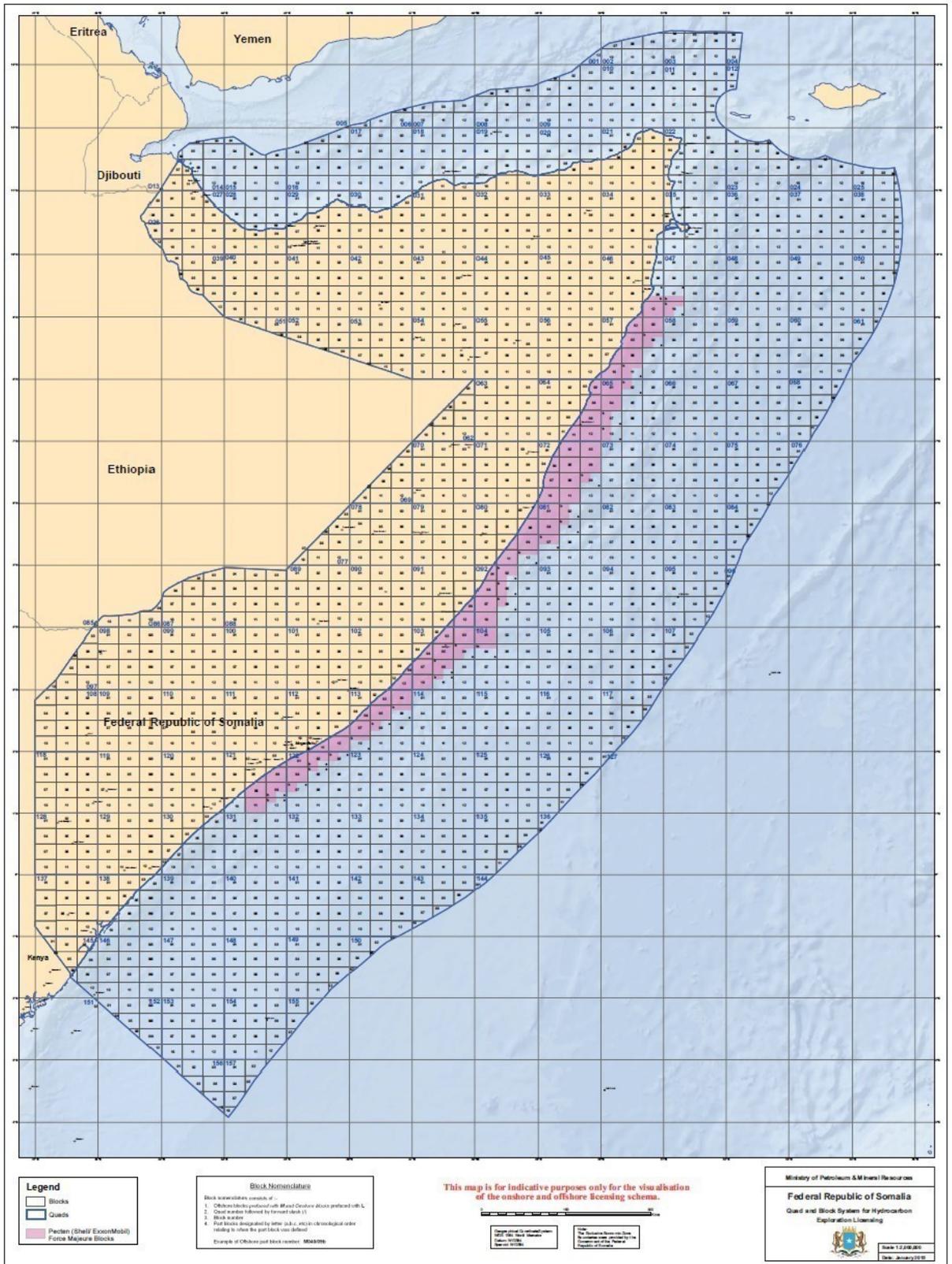
- Ibrahim Hussein, Head of External Affairs - Ministry of Petroleum and Mineral Resources (Focal point);
- Eng. Abdulkadir Abiika Hussein, Director of Hydrocarbon Exploration - Ministry of petroleum & Mineral Resources;
- Omar Mohamed ABDULLE, Lawyer - Ministry of petroleum & Mineral Resources;

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- Mohamed AHMED, Geologist - Ministry of Petroleum & Mineral Resources;

World Bank

- Matthias Mayr, ETC, Kenya.

Schedule 3 - Somali Map for graticulation of the petroleum domain - January 2015



Schedule 4 - Comments on the Proposed Revised Model PSA

The Model PSA is currently under review with the support of the African Legal Support Facility. A revised version of the Model PSA has been provided in this context to the Consultant during the workshop on the Provisional Report (the "**Proposed Revised Model PSA**").

As a general comment, it should be underlined that the Proposed Revised Model PSA includes drafting in line with the recommendations of the Consultant. Only few recommendations have not been taken into account and few points as follows appeal comments on our hand. The below table summarized the main comments of the Consultant on the Proposed Revised Model PSA.

<p>1. <u>Role of the SPA</u> The role of the SPA is considerably reduced to the benefit of the Minister of Petroleum. This should be reviewed in consideration of the decision to be taken within the Consultative Process.</p>
<p>2. <u>Definition of the Petroleum Operations</u> There could be a more explicit distinction between operations that can be done outside the Contract Area and the operations that may only be done within the Contract Area. The notion of Development does not refer to the actual purpose for which the activities are performed and also refers to maintenance of pipeline which to our opinion is related to actual production or exploitation type of operations.</p>
<p>3. <u>Parent company guarantee</u> The Proposed Revised Model PSA requires the provision by the Contractor of a parent company guarantee upon approval of the Development plan. We would advise to have this guarantee provided earlier, as from the entry into the PSA, if the PSA is to be entered into by a local specific vehicle of the foreign investor.</p>
<p>4. <u>Condition precedent to entry into force of the PSA</u> We believe for most of the condition required, it is a good idea to have them as condition precedent. We nevertheless believe that having the Decommissioning Security Agreement as condition precedent may be too early. Indeed, the decommissioning security agreement will be actually useful only once actual works are performed on sites. As per the Indemnification Find, our recommendation was to set a national fund to which each contractor would contribute, as set in the law. This is not a specific fund for the purpose of the PSA only.</p>
<p>5. <u>Drilling permit, Underground Injection Control Well Permit, Plugging and Abandonment Permit</u> These type of permits could be used (subject to modification of the petroleum law) to impose prior control of the drilling program or envisaged operations, and prior approval as recommended of an environmental impact assessment study in relation to specific operations with high environmental risk. There is however no explicit reference in the Model PSA to such control or to prior environmental impact assessment study in the process for granting these permits.</p>
<p>6. <u>Control on transfer of interest or change of control</u> The recommendations have been taken into account. Nevertheless one may regret that the requirements are not eased for transfer to an Affiliate.</p>

7. Minimum work program requirement and guarantee

There may still be confusion between the minimum work program and the guarantee to cover its performance which is used to ensure minimum exploration in the Contract area, and the approved annual work program which is used to control the level of expenditures that may be recovered as cost oil/gas. We indeed note that the Proposed Revised Model PSA states for possible revision of the minimum work program, by the Contractor, where the Contractor may incur additional expenditure in relation to the initial minimum expenditure requirement. (see Clause 5.3.5.). The Contractor shall never use such option as it is in its interest to not be bound to perform any additional minimum work. the Contractor would on the contrary need an approval of a revised annual work program to be sure that additional cost incurred in relation to the envisaged work program would be considered as recoverable costs.

The Contractor shall be bound by the minimum work requirement, not the minimum expenditure requirement. The amount set in relation to the minimum work requirement shall only be used to set the amount of the guarantee. Where the Contractor has performed the works as set in the minimum work program it shall be considered relieve of its obligations in relation to the minimum work program, even where it would not have incur as much expenditure as set in the minimum work program. (see Clause 5.3.2)

8. Appraisal

The notion of Commercial Discovery is objective and not related to a decision to be taken by the Contractor. We would instead recommend that it is only related to such decision. The use of this notion in the model PSA shall be reviewed in light of this change.

The period for the Contractor to appraise the Discovery after approval of the Appraisal work program and budget is not long enough. All the same, the additional period for which the exploration phase may be extended to perform appraisal appears very short. The average period necessary to perform appraisal work is from one year to 18 months.

The time limit to commence evaluation of the discovery does not seem adequate (two years from notice of commercial discovery. This should be the period from notice of discovery and for decision as per the development or not of the discovery (see Clause 5.6.2). Additional period may be granted where a marginal discovery or no-yet commercial discovery is made, as per with respect to gas discovery.

9. Sole risk operations

Clause 7.19 of the Proposed revised Model PSA corresponds at the sole risk type of operations. This type of clause is usually within the JOA.

10. Starting point of exploitation phase - First commercial production date

The Proposed Revised Model PSA sets two various phases for exploitation: First the development phase and then the production phase. We have no objection for such distinction. We however believe that the starting point of each of these phases could be more precisely set.

We would recommend having the development phase start with the approval of the Development Plan and the Production phase to start with the reaching of the First commercial production date. This notion is however not used within the Proposed Revised Model PSA. Please refer to Section 2.3.1 of Part 2 above for detail on this recommendation. The Proposed Revised Model PSA does not set, as recommended, a limited period of time for the contractor to start production phase, subject to termination of the contract.

<p>11. <u>Unitization</u></p> <p>The process set in the Proposed Revised Model PSA is compliant with our recommendation. We only note that there is no reference to potential case where a field would be situated on each side of the boundaries of several Member States.</p>
<p>12. <u>Management committee within the JOA</u></p> <p>The Proposed Revised Model PSA proposes not to create a management committee in the PSA, but to have only a management committee at the JOA level, within a participation of the State as an observer; approval of the annual work program and budget are to be given by the Minister (or the SPA).</p> <p>This option could also work. Nevertheless, we believe that this would result in a confusion of role between the NOC and the regulator. The JOA shall only deal with the relationship between the members of the Contractor, including as the case may be the NOC. Therefore we would recommend that a management committee be set in the PSA, although the regulator would only have a consultative / observer role in the committee.</p>
<p>13. <u>Training, employment and services</u></p> <p>The model PSA should set a preference for employment of local citizens, Somali nationals, with same skills and in the same conditions. The Proposed Revised Model PSA does not set such preference.</p> <p>The Proposed Revised Model PSA prefers to set a training fund to be managed by the minister of Petroleum instead of giving the responsibility to the Contractor ensure training, as recommended.</p>
<p>14. <u>Termination</u></p> <p>The Proposed Revised Model PSA mainly only provide for termination by the FGS for any material breach of any obligation of the Contractor in the PSA. The listed cases for termination by the FGS do not include, as recommended:</p> <ul style="list-style-type: none"> • no start in Exploration within limited period of time from entry into force of the PSA ; • no Production within a limited period of time from approval of the Development plan.
<p>15. <u>Cost recovery</u></p> <p>The Proposed Revised Model PSA set limited period of time for recovery of cost depending on the type of costs they are (exploration, development and production costs), as well as an order for such recovery. The recommendation of EY was to avoid complexity of identification of the various types of cost and allowing recovery of any type of cost following the same rules and without order.</p>
<p>16. <u>Fiscal features</u></p> <p>The fiscal terms recommended by the Consultant in this Report are based on the underlining principle that individual fiscal features should not be considered on a stand-alone basis but in conjunction with all other fiscal terms representing the overall applicable fiscal regime. If one certain feature is changed, such a change may require redesign of or significant amendments to one or all remaining features constituting an applicable framework.</p> <p>The fiscal feature in the Proposed Revised Model PSA materially varies from the fiscal framework proposed by the Consultant. Their reconciliation and the need to any adjustments to the proposed framework or the one in the Proposed Revised Model PSA need to be discussed with the involved parties.</p>

Below we outline some of the variances with the proposed framework , other than those that have not been already particularly outlined by the World Bank (e.g., overall comments about the recovery rules, including an uplift, R-factor formulae, etc):

- Article 9.1.1 suggests that the basis for the 70% cost limit applied to gross production, rather than net of royalty which is not the intention of the proposed framework;
- Article 9.1.3 suggests the introduction of an uplift of 15% for the cost recovery, which is not the intention of the proposed framework;
- Article 41.1 may not provide the clarity about taxes which are not listed and which may be regarded as not falling under the term “of general application”, e.g., excise tax or payments prescribed under Mining Regulations. Stamp tax may also not be regarded as falling under the listed categories;
- Article 41.3 mentions that the public authority’s share of Profit Oil and Profit Gas is exclusive of income taxes, which is not in line with the proposed framework regarding the corporate income tax (i.e. public authority’s share of Profit Oil and Profit Gas is inclusive of corporate income tax);
- Article 41.1.6.1 mentions the withholding tax on dividends. We would like to stress that the 10% rate for dividends is not a default recommendation to implement it, unless the government will make an informed decision that this is indeed necessary;
- Article 41.6 states that the royalty is payable in lieu of corporate income tax which is not the intention of the proposed framework;
- Article 3.14.1.5 and 3.14.1.6 of the Accounting Procedures suggests that surface fees and training fees should be non-recoverable which is not the intention of the proposed framework.