



# DIRECTORS' REPORT

PETORO AS AND THE SDFI PORTFOLIO

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# DIRECTORS' REPORT 2015

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Petoro manages the State's Direct Financial Interest (SDFI), which represents about a third of Norway's total oil and gas reserves. The company's principal objective is to create the highest possible financial value from the SDFI portfolio (the portfolio).

The SDFI was established with effect from 1985. Under this arrangement, the state participates as a direct investor in petroleum operations on the Norwegian continental shelf (NCS) so that the Treasury receives revenues and meets expenses associated with the SDFI's participatory interests directly and outside the regular system for taxing petroleum revenues. Petoro acts as the licensee for the state's participatory interests in production licences, fields, pipelines and land-based facilities, and manages the portfolio on the basis of sound business principles.

## EXTERNAL TRENDS

Global economic growth was moderate in 2015 and rather weaker than expected. Moderate growth combined with a substantial decline in crude prices have helped to boost demand for oil. But production has increased by more than demand, and resulted in a weaker market balance and stronger pressure on crude prices. The inventory build-up was substantial, and oil storage had reached a record level by 31 December. In November, Opec reaffirmed its 2014 decision to maintain an unchanged level of production. Brent Blend declined over the year to USD 37 per barrel, virtually half its top price of USD 66 in May 2015. Market volatility was also high. The average price for the portfolio came to USD 53 per barrel, compared with USD 99 in 2014. A weaker exchange rate reduced the revenue decline in Norwegian kroner, where the average price was NOK 420 per barrel – down by NOK 197 from the year before.

European demand for natural gas rose somewhat in 2015, in part because the winter was colder than in 2014. But gas is still subject to increased competition from renewable energy, coal, and the consequences of improved energy efficiency. Europe's own gas production fell further in 2015, reinforced by lower Dutch output as a result of technical challenges in the Groningen field. This decline was offset by

increased imports from Russia and Norway and as liquefied natural gas (LNG). Norway's gas exports set a record in 2015. Robust supplies and the fall in the cost of oil reduced gas prices over the year, but the weaker Norwegian krone offset the effect of this decline. The average gas price achieved for the portfolio was NOK 2.14 per scm in 2015, compared with NOK 2.23 in 2014.

Agreement was reached at the summit in Paris during December 2015 on an international climate agreement with a clear ambition of reducing global greenhouse gas emissions. That helps to increase uncertainty on the demand side.

The petroleum sector is also under considerable pressure to reduce total emissions from oil and gas production, which means the industry must develop low-emission solutions and enhance energy efficiency.

Substantial changes are under way in the petroleum industry. Great uncertainty prevails over future oil price developments, profitability and competitiveness. The sector is characterised both in Norway and internationally by investment cut-backs and downscaling of the level of activity, which are reflected by the reduced scope of new projects.

Commitment to cost reductions and greater efficiency increased during 2014 and 2015. The need to secure a rapid improvement in cash flow was directed moreover at reduced activity, cost/benefit assessment of measures, simplification and standardisation of solutions and work processes, improved planning and renegotiation of contractual rates. The measures initiated have had a big impact in certain areas, such as drilling and field costs. A substantial potential still exists for further efficiency improvements through innovative technology, better collaboration between players and new

operating models. Such measures will take longer to identify and implement, since they call for substantial changes in the way the industry works.

Current efficiency improvements and initiatives to reduce the level of costs in the industry are crucial for improving profitability both in the near future and in the long term. Greater emphasis on financial robustness challenges profitability and the choice of solutions in projects. The scope and speed of this improvement work affects Petoro's opportunities to realise the value potential of the portfolio for both mature fields and possible new field developments.

### SUMMARY OF SDFI RESULTS

Financial results for the SDFI in 2015 were strong despite the significant reduction in commodity prices from the year before. Net income in 2015 came to NOK 89 billion, down by NOK 31 billion from 2014. Cash flow to the government was NOK 94 billion, 15 per cent lower than the year before despite a halving of oil prices in US dollars from 2014 to 2015.

A weaker exchange rate against the US dollar helped to maintain revenues measured in Norwegian kroner. Gas revenues represent an increasingly important share of SDFI income. Relatively stable prices combined with higher sales maintained good gas earnings. Total production averaged 1 068 000 barrels of oil equivalent per day (boe/d), about seven per cent higher than in 2014. That primarily reflected improved production efficiency (PE) and the completion of more wells. Some gas production was also transferred from 2014 to 2015. Sales for the year corresponded to production.

Investment for 2015 totalled NOK 28 billion, down by NOK 8 billion from the year before. This decline was in line with expectations and primarily reflected lower capital spending on development and operations as a result of reduced project activities.

At 31 December 2015, the portfolio's expected remaining oil, condensate, NGL and gas reserves comprised 6 276 million boe. That was up by 130 million boe from the end of 2014 when account is taken of production for the year and new reserves. The increase in the portfolio's reserves is attributable almost entirely to the decision to develop Johan Sverdrup.

The book value of assets totalled NOK 248 billion at 31 December 2015. These assets

comprise operating facilities related to field installations, pipelines and land-based plants, as well as current debtors. Assets have been assessed for impairment in light of the low oil prices. Impairment charges of about NOK 5 billion were taken in 2015. Equity at 31 December amounted to NOK 161.5 billion.

### HEALTH, SAFETY AND THE ENVIRONMENT (HSE)

The general improvement in HSE results is continuing, but was overshadowed by the fatal accident of 30 December 2015 on the COSL Innovator drilling rig, which was working on the Troll field. The serious incident frequency declined from 0.7 per million working hours in 2014 to 0.5. The personal injury frequency also made progress, falling from 3.8 in 2014 to 3.3. No large individual discharges of oil to the sea or on land occurred in 2015.

Major restructuring and change processes in the industry are influencing the risk picture, and Petoro paid particular attention to this aspect during 2015 when following up HSE and technical integrity. Special attention was again devoted during the year to major accident risk. The company also participated in a number of HSE visits by management to selected fields and installations in 2015. No negative consequences for HSE, maintenance and PE have so far been identified.

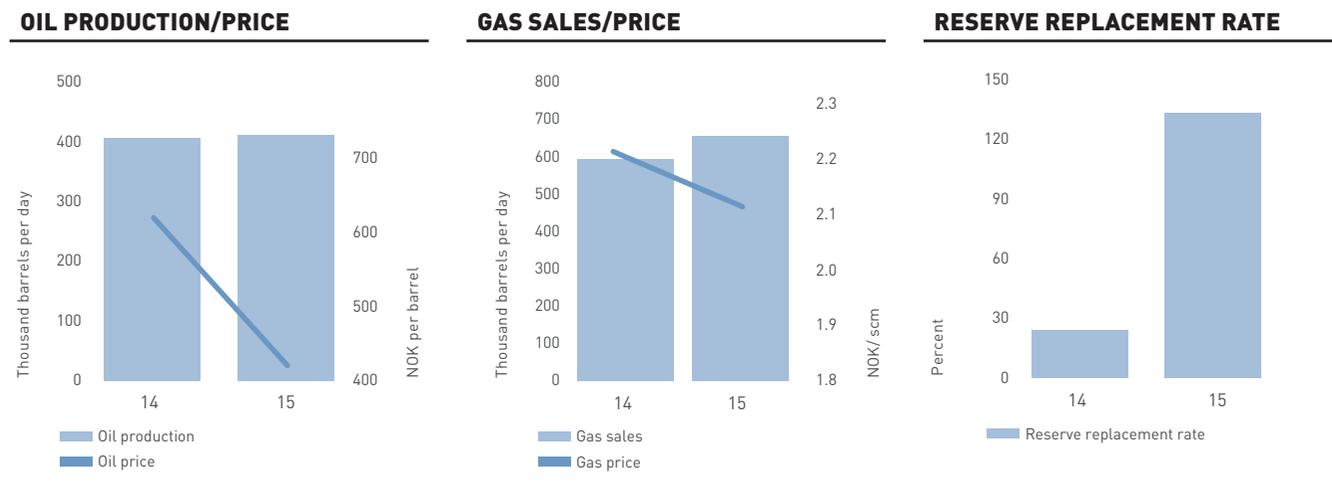
### PRINCIPAL ACTIVITIES IN 2015

The portfolio comprised 174 production licences at 31 December, a reduction of eight from 1 January. Participatory interests in 13 production licences were awarded for Petoro to manage through the 2015 awards in predefined areas (APA) in January 2016.

The company's strategy was last revised in 2013, and its most important elements have been a concentration on mature fields, field development and the far north. A decision to initiate a new strategy process was taken by the board in the autumn of 2015, and plans call for this work to be completed during the first half of 2016.

Output from the mature oil fields continues to dominate production in the portfolio. Troll, Åsgard, Oseberg, Heidrun, Snorre and Gullfaks accounted for about 60 per cent of total liquids production.

Just over 70 per cent of gas output came from Troll, Ormen Lange and Åsgard. New capacity was introduced in 2015 when Åsgard subsea



compression, Valemon, Oseberg Delta 2, Troll gas compression and Eldfisk II came on stream. In addition, Gullfaks wet gas compression was installed during the year but did not begin operation.

In line with the strategy, work continued in 2015 on realising the reserve base and supplementary resources in the mature fields, with special commitments made to Snorre, Heidrun and Oseberg.

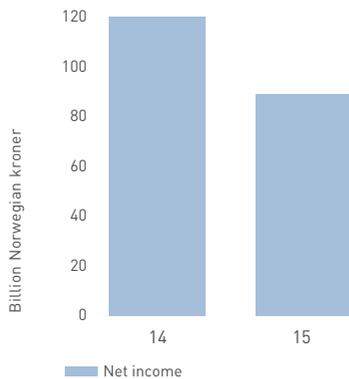
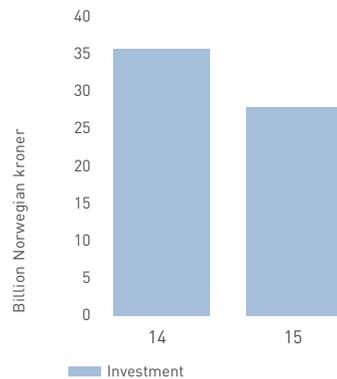
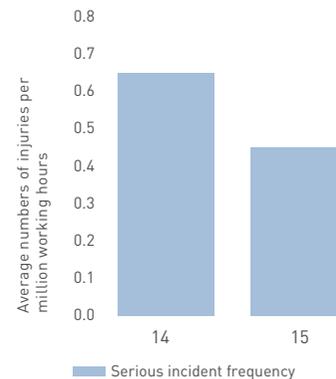
With today's high level of costs and low raw material prices, companies on the Norwegian continental shelf (NCS) are devoting great attention to improving profitability and cash flow. Petoro is finding that short-term considerations wrestle with longer-term concerns. This makes it challenging to secure the necessary decisions which are important for long-term value creation, and not least to ensure that these are taken at the right time.

Petoro is an active driving force on the Snorre 2040 project, and contributed through its own work in 2015 to strengthening the reserve potential for a major new development solution. Challenging profitability prompted yet another postponement of the decision on continuation to the fourth quarter of 2016 and the introduction of a new concept based on subsea solutions as an alternative to a new Snorre C platform. Petoro has made its own assessments of the opportunities offered by a new concept for securing a realisation of the greatest possible value from further development of the field. Current plans call for an investment decision in 2017 and a start to production in 2021. The new solution makes it possible to realise Petoro's ambition.

Through its own simulation studies on Heidrun, Petoro has increased understanding of the reservoir in the northern parts of this field where the potential for improved recovery is greatest. This work has helped to reduced uncertainty and strengthen the reservoir potential for the Heidrun subsea extension project, with a choice of concept planned for early 2017.

The contribution made by Petoro to Oseberg in 2015 was directed at improving the drainage strategy and ensuring robustness in the Oseberg future development project. A decision has been taken on a new simple and unstaffed wellhead platform as the first stage of the Oseberg Vestflanken 2 project. This innovative solution is entirely in line with Petoro's view, and could open new opportunities for further field development. A plan for development and operation (PDO) was submitted in December 2015, with production planned to begin in 2018.

Petoro's commitment to Johan Sverdrup in 2015 was linked to an integrated development of the field and to ensuring robust procurement strategies for its first stage. The PDO for phase one was submitted in February 2015 with a development solution which, in line with Petoro's view, lays the basis for good long-term value creation. Where future phases are concerned, an expansion of production capacity with a new platform at the field centre will provide the greatest long-term value creation. Petoro worked in 2015 to ensure that this structure will be as cost-effective as possible, and secured acceptance for further maturation of the concept up to decision gate 2 (DG2) in the autumn of 2016.

**NET INCOME****INVESTMENT****SERIOUS INCIDENT FREQUENCY**

The company continued its own analysis work on the value potential of advanced improved recovery from Johan Sverdrup, and proposed solutions in this area. The licensees are planning a pilot project for such recovery after phase one has come on stream. Petoro has also sought to establish a robust basis for electricity supply capacity which ensures sufficient power in the long term.

Extensive work related to the unitisation of Johan Sverdrup was completed by Petoro during 2015, and a negotiated unitisation agreement was presented to the government for determination of the final terms in conjunction with the submission of the PDO in February 2015. The Ministry of Petroleum and Energy (MPE) decided on a division of Johan Sverdrup on 1 July 2015 which gave the SDFI a 17.36 per cent holding in the field.

In the far north, Petoro's attention has been concentrated on the portfolio in Barents Sea South with the emphasis on Snøhvit, Johan Castberg and the Hoop area.

Where the Johan Castberg project is concerned, Petoro continued to focus during 2015 on improving profitability and enhancing the robustness of alternative concepts assessed by the licensees. A decision on continuation (DG2) was postponed in February 2015 to the third quarter of 2016, and the licensees opted in December 2015 for a production ship as the development concept. Petoro has contributed to ensuring that the chosen solution has sufficient processing capacity to provide tie-back opportunities for possible supplementary resources in the area.

Petoro continued to direct the industry's attention during 2015 towards the need to speed up the pace of drilling through improved efficiency and cost reductions in the drilling and well service area. The company has followed up progress with drilling speed from 10 fixed installations on five fields over several years, and has seen a doubling in the number of wells there over the past two years along with a halving in drilling costs for each well. This reflects a combination of more efficient drilling, simplification of well design and increased availability of drilling facilities.

Growing attention was paid by Petoro in 2015 to the need for improved efficiency also in development, operation and maintenance. The company worked to ensure that the measures adopted are sustainable in both short and long terms, and involve a genuine enhancement in efficiency rather than simply a reduction in activity. The aim is to increase competitiveness and thereby ensure the profitability of investment in mature fields and new developments. Petoro observed that field costs related to some important fields were also substantially reduced from the 2013 level during 2015. In addition, restructuring efforts by the operators contributed to big reductions in operational modifications. Achieving further cost reductions is expected to be more challenging.

Four PDOs were approved by the government in 2015, covering Gullfaks Rimfaksdalen, Johan Sverdrup phase one, Maria and Gullfaks Shetland/Lista. The PDO for Oseberg Vestflanken 2 was adopted by the licensees and submitted to the MPE in December.

Exploration activity on the NCS was high in 2015.

Petoro participated in 13 of the 57 exploration wells completed during the year. Seven new but small discoveries were made in the portfolio.

Reserves increased substantially over the year, primarily as a result of the development decision for Johan Sverdrup. The overall rise for the portfolio over the year was 520 million barrels of oil equivalent (boe). A total of 390 million boe was produced in 2015, giving an estimated net reserve replacement rate of 133 per cent. The comparable figure in 2014 was 24 per cent.

### **RESEARCH AND DEVELOPMENT**

Petoro contributes to research and development (R&D) through the SDFI meeting its share of these costs, with the funds managed by the respective operators. This amounted to NOK 581 million in 2015. In addition come projects directed at field-specific qualification of new solutions or an initial application, where the costs are charged to the licensees as part of the investment budgets in the joint ventures. Petoro does not initiate its own technology development and research projects.

### **MARKETING AND SALE OF THE PRODUCTS**

All oil and natural gas liquids (NGL) from the portfolio is sold to Statoil. The latter is responsible for marketing all the SDFI's natural gas together with its own gas as a single portfolio, but at the government's expense and risk. Petoro is responsible for monitoring that Statoil's sales of the SDFI's petroleum achieve the highest possible value, and for ensuring a rightful division of total value creation. Petoro concentrates in this work on Statoil's marketing and sales strategy, issues of great significance in value terms, matters of principle and questions relating to incentives.

Petoro has given priority to evaluating the formulae for oil and NGL in order to assess whether the goals in the marketing and sale instruction concerning Statoil's marketing and sale of the government's oil and gas are met. The company has also prioritised work related to maximising value creation in the gas portfolio to ensure that available gas is sold in the market at the highest possible price and that the flexibility in the production facilities and transport capacity is exploited to optimise sales. Petoro has also devoted attention to the role of gas in Europe's future energy mix, and has followed the development of EU energy and climate policies.

Checks were conducted to ensure that the SDFI

was getting a rightful share of sales-related costs and revenues.

### **WORKING ENVIRONMENT AND EXPERTISE**

The company's human resources policy will ensure diversity and equal opportunities, develop expertise, facilitate a good working environment, and prevent discrimination on the grounds of age, gender or cultural and geographical background.

Personnel in Petoro have long experience from the petroleum industry and a high level of education. The individual employee is crucial to the company's deliveries and success, and the board gives emphasis to ensuring that Petoro offers competitive terms and a stimulating working environment which attracts people with the right expertise and positive attitudes. Opportunities for professional and personal development will help to retain, develop and attract able personnel. In light of the Norwegian pension reform, Petoro has made changes to its pension scheme which came into effect on 1 January 2016.

Petoro had 64 employees at 31 December 2015, compared with 67 a year earlier. Three members of staff resigned during the year, while two others retired. Two new appointments were made. No occupational accidents were recorded among Petoro's personnel in 2015.

Women accounted for 39 per cent of the total workforce in 2015, and for 57 and 38 per cent of the company's directors and executive management respectively. Petoro emphasises equality between the genders in terms of opportunities for professional and personal development as well as pay. The company customises working conditions so that people with disabilities can also work for Petoro. Sickness absence came to 1.8 per cent, compared with 2.5 per cent in 2014. Petoro has an inclusive workplace (IA) agreement, and gives weight to close follow-up and dialogue to promote good health and prevent sickness absence.

Collaboration with the company's working environment committee (AMU) and works council (SAMU) lays an important basis for a good working environment in the company. Work in these bodies again functioned well in 2015.

### **CORPORATE GOVERNANCE**

The board gives weight to good governance to ensure that the portfolio is managed in a way

which maximises financial value creation in a long-term perspective. Requirements for governance in the public sector are specified in the government's financial regulations and in standards for good corporate governance. The board observes those sections of the Norwegian code of practice for corporate governance regarded as relevant to Petoro's business and to the frameworks established by its form of organisation and ownership.

The management system is tailored to Petoro's distinctiveness, and has been further developed in line with organisational changes during the year. See the separate section in the annual report for further details.

Petoro's values base and ethics are embedded in its values and guidelines on business ethics.

### **CORPORATE SOCIAL RESPONSIBILITY (CSR)**

Petoro discharges its CSR in line with the company's guidelines for exercising such responsibility, which are tailored to its role. Funding for discharging its management duties and for running the company is provided through appropriations from the government, and Petoro is unable to provide monetary support for social purposes.

Measures which ensure that Petoro discharges its CSR include ethical guidelines, openness on money flows and anti-corruption work, the HSE declaration, and an HR policy which ensures diversity and equal opportunities. Petoro reports annual cash flows related to the portfolio to the extractive industries transparency initiative. The board provides a more detailed presentation of the exercise of CSR in a separate section of the annual report.

### **RISK MANAGEMENT AND INTERNAL CONTROL**

The board conducted an assessment of the risk picture in 2015 on the basis of the approved strategy, and set targets for the coming year. Measures were identified for reducing the most significant risks which Petoro has an opportunity to influence within the frameworks established for it. The company updated its methodology and format for risk management during the year.

Two internal audit projects implemented in 2015 evaluated Petoro's processes for IT-related suppliers and external IT security respectively. The results were summed up in reports to the board which describe the checks undertaken,

the findings made and the measures proposed and implemented. Internal audit projects in 2015 were implemented by Deloitte. With effect from 1 July 2015, the internal audit function in Petoro AS has been outsourced to PricewaterhouseCoopers. The latter will also conduct the internal financial audit for the SDFI from fiscal 2015.

### **WORK OF THE BOARD**

The board held 11 meetings in 2015. It has established a meeting and work plan with the emphasis on the consideration of strategy, goals, budgets and interim results. The board is concerned with value creation from the total portfolio, and with ensuring that the state receives its rightful share and does not get charged a larger proportion of costs than is warranted. Balanced scorecards are a key instrument used by the board in following up the company's results, and it measures the results achieved against established commercial and organisational goals.

The board considers major investment decisions in the portfolio, and follows up and considers the commercial business, including monitoring Statoil's duties under the marketing and sale instruction. It also monitors the company's overall risk picture. The board ensures that control systems have been established and that the business is conducted in compliance with the company's values base and guidelines on business ethics. A declaration has been drawn by the board on the remuneration of the chief executive and senior personnel. The board has organised its preparatory work on compensation arrangements in a sub-committee.

Conflicts of interest are a fixed item on the agenda at board meetings, and directors with such a conflict withdraw from the board's consideration of the relevant issue. The board conducts an annual evaluation of its own work. That also includes a review of the company's guidelines on business ethics and CSR, and the instructions for the board. Changes to its instructions and the business ethics guidelines were considered by the board in 2015. It has been underlined in the instructions that directors must routinely report on their ownership of shares or the like in other companies which could involve or which could be perceived as involving a conflict of interest with their position. Furthermore, they are required to report other relationships with licensees involved in petroleum activities on the NCS or with companies which deliver to licensees. The board also considered changes

to the company's guidelines on business ethics, which were supplemented by a ban on senior executives owning shares in licensee companies.

Each director and the board as a collective body seek to strengthen their expertise in various ways. These include participation in courses and conferences and generally following developments in the area.

Petoro's board comprises Gunn Wærsted as chair, Hilde Myrberg as deputy chair, Per Arvid Schøyen, Trude J H Fjeldstad and Per-Olaf Hustad as shareholder-elected directors, and Marit Ersdal and Lars Kristian Bjørheim as directors elected by and from among the employees.

#### **PETORO AS AND THE GROUP SHARE CAPITAL AND SHAREHOLDER**

Petoro AS was established as part of the restructuring of the state's oil and gas activities in 2001, when Statoil was part-privatised and management of the SDFI was assigned to Petoro. The company's operations are regulated by chapter 11 of the Petroleum Act. Its general meeting is the Ministry of Petroleum and Energy.

The company's share capital at 31 December 2015 was NOK 10 million, divided between 10 000 shares owned by the Ministry of Petroleum and Energy on behalf of the Norwegian government. Petoro's business office is in Stavanger.

#### **PETORO ICELAND AS**

Petoro Iceland AS was established in December 2012 as a wholly owned subsidiary of Petoro AS. Through a branch registered in Iceland, it is a licensee and participant in production licences where the Norwegian government decides to participate. The company's share capital at 31 December 2015 comprised NOK 2 million, divided between 2 000 shares. It has no employees and has entered into a management agreement with Petoro.

#### **NET INCOME AND ALLOCATIONS**

Petoro AS maintains separate accounts for all transactions relating to participatory interests in the joint ventures. Revenue and expenses for the portfolio are kept apart from operation of the company. Cash flow from the portfolio is transferred to the central government's own accounts with Norges Bank. Accounts for the portfolio are presented both on the cash basis used by the government and in accordance with

the Norwegian Accounting Act and Norwegian generally-accepted accounting principles (NGAAP).

Funds for operating Petoro AS and Petoro Iceland AS are provided by the government, which is directly liable for the commitments accepted by the companies. The consolidated accounts embrace the parent company and Petoro Iceland AS. Amounts related to internal transactions are eliminated in the consolidated accounts.

NOK 331.2 million (including VAT) was appropriated for ordinary operation of Petoro AS in 2015, and the appropriation for Petoro Iceland was NOK 22.5 million.

Operating expenses in 2015 were NOK 266.4 million for the parent company and NOK 283 million (excluding VAT) for the group. They related primarily to payroll and administration expenses and to the purchase of external services. The company prioritised spending substantial resources and study funds on mature fields and work on the Johan Sverdrup development.

Net profit came to NOK 5 million for the parent company and NOK 4.5 million for the group. The board proposes that this profit be transferred to other equity, which amounted to NOK 11.8 million at 31 December 2015. The group's reserves of NOK 13.4 million comprise other equity in the parent company, NOK 2 million in grants from the Norwegian government related to establishing Petoro Iceland and accumulated results in the subsidiary.

Pursuant to section 3, subsections 3 and 2a, of the Norwegian Accounting Act, the board confirms that the annual accounts for the portfolio and the company provide a true and fair picture of the company's assets and liabilities, financial position and results of the business, and that the annual accounts have been prepared on the assumption that the company is a going concern. The company has a satisfactory equity and low financial risk.

The board initiated a strategy process in 2015 and followed up the organisational changes and efficiency improvements launched to ensure that Petoro is as well equipped as possible for tackling the challenges and opportunities involved in managing the portfolio within available resources.

## PROSPECTS

It appears likely that the time to come will also be characterised by a weakened balance between supply and demand and pressure on oil and gas prices. The international debate on climate conditions challenges the position of fossil fuels in the future global energy mix, and increases uncertainty about the market outlook for oil and gas.

The board notes that all players in the industry are working to enhance cost efficiency on a broad basis. This represents an important basis for future profitability. The board expects the competitiveness of the NCS to be strengthened as a result of current improvement measures, which are likely to yield a further reduction in the level of costs.

Ensuring the profitability of drilling a large number of new production wells is necessary for realising the value in the mature fields on the NCS. Success here within the producing life of the fields calls for lasting cost reductions, a high pace of drilling and reduced uncertainty over potential volumes. However, achieving genuine efficiency gains at a substantially lower level of costs will require hard work for a long time to come both by operators and at all stages in the supplier chain. For further

efficiency measures to succeed, work must be pursued with new technological opportunities and with continued development of an open and trusting collaboration between operator and suppliers at all levels. Should these efficiency efforts prove successful, a great potential for new commercial opportunities continues to exist on the NCS. It is also important that the maturation of projects does not come to a halt and that more developments get driven forward to decision than the number being submitted to the partnerships at present.

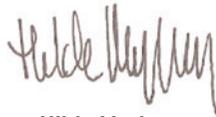
The board expects portfolio transactions between players on the NCS to increase as a consequence of a challenging market and a changed strategic focus among the companies. That could influence partner composition in the licences and opportunities for realising new production.

Exploration activity resulting from awards in the 23rd licensing round in the Barents Sea will be crucial for the pace of further development in the far north, and probably also for the addition of major new projects and new production after 2020.

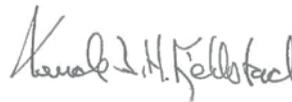
Stavanger, 4 March 2016



**Gunn Wærsted**  
Chair



**Hilde Myrberg**  
Deputy chair



**Trude J H Fjeldstad**  
Director



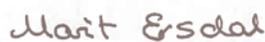
**Per Arvid Schøyen**  
Director



**Per-Olaf Hustad**  
Director



**Lars Kristian Bjørheim**  
Director\*



**Marit Ersdal**  
Director\*



**Grethe K. Moen**  
President and CEO

\*Elected by the employees