DIRECTORS' REPORT

PETORO AS AND THE SDFI PORTFOLIO

Dvalin – Illustration: DEA

DIRECTORS' REPORT 2016

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

The SDFI scheme was established in 1985. Under this arrangement, the state participates as a direct investor in petroleum activities on the Norwegian continental shelf (NCS), so that the state receives revenues and meets expenses associated with SDFI's ownership interests. As SDFI manager, Petoro contributed a cash flow of nearly NOK 66 billion in 2016, which represents a significant portion of the state's total revenues from the petroleum activities. Petoro acts as licensee for the state's ownership interests in production licences, fields, pipelines and onshore facilities, and manages this portfolio based on sound business principles.

EXTERNAL TRENDS

Global economic growth in 2016 was around 3 per cent, which was in line with expectations. In combination with weak oil prices, this contributed to continued growth in global demand for oil, around 1.4 million barrels (bbls) per day in 2016. The price of oil fell below USD 30 per barrel (bbl) in January 2016, but rose substantially towards the summer, based on an expected rebalancing in the market. However, this rebalancing has taken longer than first expected. Despite regular announcements from OPEC countries concerning the necessity of production cuts, production from both OPEC and Russia was higher, while the decline in US shale oil production levelled off. In November, OPEC adopted an agreement mandating production cuts of 1.2 million bbls per day, with the support of certain non-OPEC countries such as Russia. This helped facilitate a stabilisation of the oil price towards the end of the year at around USD 55 per bbl, which was nearly double the price at the beginning of the year. The average price for the year was Norwegian kroner (NOK) 361 per bbl, down NOK 59 from 2015.

European demand for gas in 2016 was somewhat higher than the previous year. The increase was partly a result of lower temperatures, but also higher demand from the power sector in several European countries. Power prices rose in the autumn of 2016 as a consequence of the shutdown of several nuclear power plants, which also contributed to bolster profitability for gas power plants. A significant increase in coal prices was also a contributing factor in improving the competitiveness of gas in the power sector. Russian gas exports to Europe reached record levels in 2016, while LNG imports were lower than expected. Norwegian gas exports remained at approximately the same level as the previous year. Ample gas supplies caused considerable pressure on prices in Europe throughout the year. Prices below NOK 1 per Sm^3 were quoted in August. Prices rallied towards the winter resulting from factors such as low temperatures and increased demand from the power sector. The average gas price achieved for the portfolio was NOK 1.62 per Sm^3 in 2016, compared with NOK 2.14 per Sm^3 in 2015.

A more negative scenario has emerged throughout 2016 as regards long-term demand for both oil and gas. The Paris Agreement was ratified in November and lays the groundwork for a levelling, and ultimately declining, demand for fossil fuels. The EU has confirmed its ambition to achieve comprehensive decarbonisation over the longer term. This commitment places particular focus on energy efficiency – in addition to renewable energy – as important components in reducing consumption, particularly of gas.

As a response to Norway's climate commitments, the industry has worked with the Norwegian Oil and Gas Association in 2016 to establish a road map leading up to 2030 and 2050. This road map includes concrete and ambitious reduction targets for emissions from production and maritime activity on the Norwegian Shelf. The industry will work systematically to develop and implement an operating philosophy along with technology that fosters emission reductions. Examples of proposed measures include low-emission solutions in new projects and energy efficiency measures in existing facilities.

The comprehensive adjustment that the oil and gas industry has undergone in recent years has yielded results. Major cost reductions have been achieved in both operation of facilities and in new projects. Substantial efficiency improvements have also been made, for example in drilling progress and regularity. This development paves the way for new, profitable projects on the Norwegian Shelf. However, the situation is still characterised by significant uncertainty regarding the future price development for oil and gas, profitability and competitiveness. The industry has cut back its investment plans, both in Norway and globally. As a result, further activity linked to development of new production capacity on the Norwegian Shelf is expected to stabilise at a lower level than previously.

A strong driving force in this transformation has been the need for rapid cash flow improvement. The improvement efforts have been aimed at reduced activity, cost/benefit assessment of measures, streamlining and standardisation of solutions and work processes, better planning and renegotiation of contract rates. Further streamlining and initiatives are needed to reduce cost levels and improve profitability in the sector, both short-term and long-term. The potential is great through application of new technology, improved cooperation between players in the supply chains and new operating models. Such measures will entail a comprehensive change in the way the industry works, which means that implementation will take time.

SUMMARY OF SDFI RESULTS

The financial result for 2016 was a net income of NOK 57 billion, NOK 32 billion lower than in 2015. Cash flow to the state was NOK 66 billion in 2016, 30 per cent lower than in 2015.

Significantly lower oil and gas prices in 2016, compared with 2015, impacted both the cash flow and the financial result for the year. Total production was 1 040 000 bbls of oil equivalents (o.e.) per day. Production was 3 per cent lower than in 2015, primarily due to lower gas production. The high gas production in 2015 was due to shifting gas volumes from 2014 to 2015. Regularity remained good in 2016.

Investments in 2016 amounted to NOK 28 billion, which is the same level as the previous year. Production drilling accounts for approximately one-half of the investments.

The book value of assets at 31 December 2016 was NOK 241 billion. The assets consist of operating facilities related to field installations, pipelines and onshore plants, as well as current debtors. Year-end equity was NOK 153 billion.

HEALTH, SAFETY AND THE ENVIRONMENT (HSE)

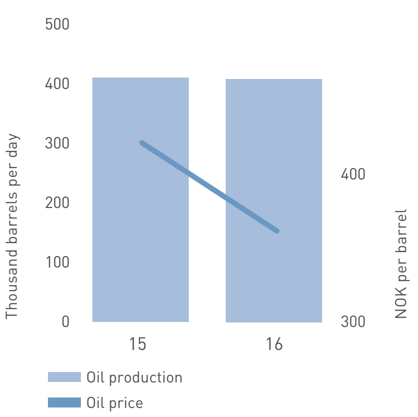
2016 was marked by the tragic helicopter accident near Turøy on 29 April in which 13 people lost their lives. There has also been an increase in serious near-miss incidents throughout the year, which has resulted in intensified focus on the part of both licensees and the Petroleum Safety Authority. This very negative development is reflected in Petoro's HSE results, where the serious incident frequency (number of serious incidents per million hours worked) increased from 0.5 in 2015 to 1.0 in 2016. The personal injury frequency (number of personal injuries per million hours worked) has also developed negatively, and the result was 4.1 in 2016 compared with 3.3 for the previous year. No serious discharges to sea were recorded in 2016.

The comprehensive transition and change processes in the industry impact the overall risk picture. Petoro has addressed this in 2016 as a topic in the work to follow up major accident risk in the licences. A number of management visits have been conducted in 2016 as well, focusing on health, safety and the environment on selected fields and installations.

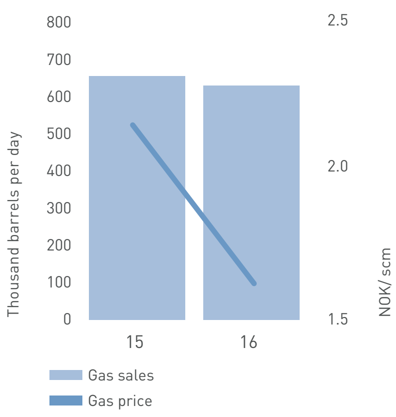
PRINCIPAL ACTIVITIES IN 2016

As of the end of 2016, the portfolio consisted of 180 production licences, 6 more than at the beginning of the year. In January 2016, Petoro was awarded participating interests in 13 production licences in predefined areas (APA 2015). In the 23rd licensing round in May 2016, Petoro was granted participating interests in 5 production licences, all in the Barents Sea,

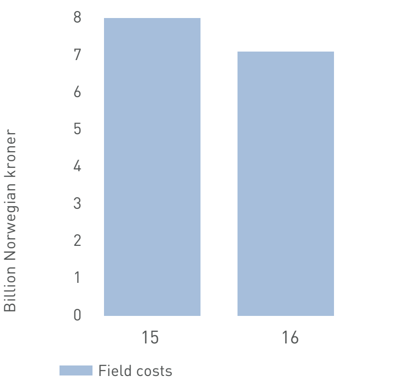
OIL PRODUCTION/PRICE



GAS SALES/-PRICE



FIELD COSTS



where two exploration wells are expected to be drilled in 2017. Petoro also received participating interests in 13 production licences in predefined areas (APA 2016) in January 2017.

The company's strategy was revised in 2016. Through focused follow-up, supported by in-depth professional commitment, Petoro will reinforce value creation opportunities with emphasis on long-term business development. This is a two-part strategy: Increase the competitiveness of the portfolio and realise value in mature fields.

The board considers the company's climate policy, which was established in 2016, as a step toward realising the strategy. The policy emphasises Petoro's contribution to ensuring that the oil and gas industry on the Norwegian Shelf leads the way in addressing climate challenges.

The main effort exerted by the company aims at influencing decision processes in the licences. Petoro is also a driving force for improving and further developing activity on the Norwegian Shelf through active dialogue with the industry, based on own analyses.

Production from mature oil fields continues to dominate oil production in the SDFI portfolio. Troll, Åsgard, Oseberg, Heidrun, Snorre and Gullfaks accounted for 60 per cent of total liquids production. Approximately 70 per cent of the gas production came from Troll, Ormen Lange and Åsgard. In 2016, gas accounted for 61 per cent of overall production.

In keeping with the strategy of realising value in mature fields, particular effort has been devoted to Snorre, Heidrun and Oseberg in 2016.

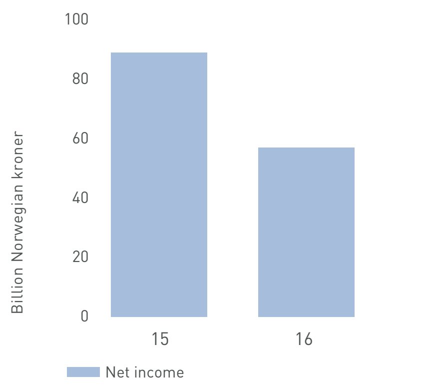
For many years, Petoro has been a strong advocate for realising profitable reserves on Snorre. These efforts have mainly been aimed at reinforcing the reserve potential, and have contributed to a December 2016 licence decision to continue a further development project based on a seabed solution that will provide for 24 new wells. An investment decision is planned in 2017, with production start-up in 2021. This expansion project will facilitate the realisation of significant remaining values in Snorre.

On Heidrun, Petoro has used its own simulation studies to increase understanding of the reservoir, and has contributed to increased basis reserves on the field. A concept selection for Heidrun lifetime extension was made in 2016, and this will facilitate long-term maturing of reserves. The efforts have largely focused on establishing a robust resource base for further development of the field, with particular emphasis on the northern parts.

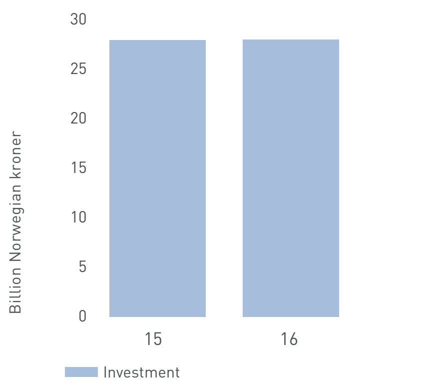
Petoro's efforts on Oseberg in 2016 have focused on increasing the resource base and thus laying the groundwork for new investments in the "Oseberg further development" project.

Work got under way in the Troll licence in 2016 to assess the possibility of producing the gas cap in Troll Vest (Troll phase 3). Petoro has contributed to the scope and timeframe for the work to ensure a comprehensive approach to

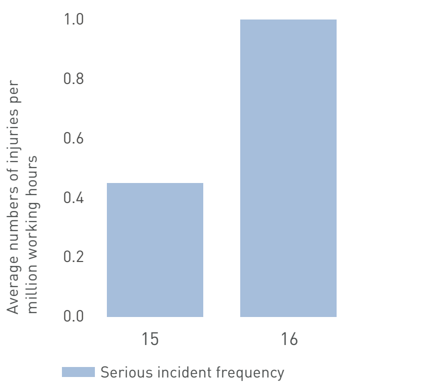
NET INCOME



INVESTMENT



SERIOUS INCIDENT FREQUENCY



further development of the Troll field.

Johan Sverdrup phase 2 and Johan Castberg are two major projects currently in the planning stages. Petoro's focus in 2016 has been on contributing to improved profitability and future-oriented development solutions that will allow sound further development in the operations phase. A decision to continue project planning was made for Johan Castberg in December 2016 with a production ship as the development concept. An investment decision is planned in the licence in 2017, with production start-up in 2022.

One plan for development and operation (PDO) with SDFI participation was approved in 2016: Oseberg Vestflanken 2. A PDO was also submitted to the authorities for Dvalin (PL 435) in October 2016. Petoro became a licensee in December, following takeover of a 35 per cent ownership interest in the licence. The plan is to develop Dvalin with tie-in to Heidrun and gas transport via Polarled and Nyhamna. The authorities approved the PDO in January 2017.

The need for streamlining and cost reductions within the drilling and well service area has been an important issue for Petoro over several years. As part of this effort, Petoro has monitored the development in drilling pace on 10 fixed installations on 5 selected fields in the portfolio. For this selected sample, the number of wells has doubled and drilling costs per well have been cut in half over the last three years. This result can mainly be attributed to increased drilling efficiency, simplified well design and increased availability of drilling facilities.

As part of the strategy, Petoro has focused on enhancing the competitiveness of the portfolio. Consistent improvements have been achieved in all areas in the value chain, as illustrated by reduced investment estimates totalling NOK 15 billion (SDFI share) for the three major new projects: Johan Sverdrup, Johan Castberg and Snorre expansion. Recoverable resources for these major new projects are virtually unchanged, which means that competitiveness has increased, and provides a better basis for maturing profitable new projects in the portfolio. Another example of the results of improvement efforts is the 24 per cent reduction in field costs for producing fields since 2013.

Petoro works continuously to ensure that measures implemented to reduce costs are sustainable in both the short and long term perspective, and that they entail actual efficiency improvements, not just reduced activity.

Petoro is concerned with ensuring that the substantial rig capacity committed to the SDFI portfolio is utilised in value-generating activity in the licences and not left idle. There is still a considerable need to drill new wells in mature fields in order to realise the value potential, and drilling makes up a considerable share of investments in long-term prognoses.

Following a number of years of high exploration activity, 36 exploration wells were drilled on the Norwegian Shelf in 2016, down 20 from the year before. Petoro participated in 12 of the exploration wells completed during the year. A total of 5 new and generally minor discoveries were made in the SDFI portfolio; 4 of which are considered to be commercial. The largest is the gas/condensate discovery Herja, northeast of Martin Linge, with a preliminary resource estimate between 2 and 11 million Sm3 of recoverable o.e. The plan is to produce these volumes from Martin Linge.

At the end of 2016, the portfolio's anticipated remaining reserves of oil, condensate, NGL and gas amounted to 5968 million barrels of oil equivalent (boe). This is down 308 million boe from the end of 2015. The reduction in SDFI portfolio reserves is mainly attributed to production, in addition to the fact that there have been no major development decisions in 2016.

RESEARCH AND DEVELOPMENT

Petoro contributes to research and development (R&D) through the SDFI meeting its share of these costs in the production licences. The funds are managed by the respective operators. This amounted to NOK 546 million in 2016. Additionally, projects aimed at field-specific qualification of new solutions or pilot application of technology in licences, where the costs are charged to 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 are sold to Statoil. Statoil 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 equitable allocation of total value creation. In this work, Petoro concentrates on Statoil's marketing and sales strategy, issues of great significance in value terms, matters of principle and questions relating to incentives.

In 2016, Petoro has prioritised focus on the implementation of a new follow-up system for sale and marketing. Furthermore Petoro has contributed to introduction of a revised formula for LPG from 2017.

The continued demanding market situation in oil and gas has led the company to devote attention to ensuring that the products are sold in markets where the highest price can be achieved. Optimum utilisation of the capacity and flexibility in production facilities and infrastructure is of great significance in this context, and follow-up has been important.

The role of gas in Europe's future energy mix is increasingly challenged by EU energy and climate policy. Petoro is keeping a close eye on this development.

Verifications have been conducted to ensure that SDFI receives its rightful share of sales-related costs and revenues.

WORKING ENVIRONMENT AND EXPERTISE

The company's human resources policy aims to ensure diversity and equal opportunities, develop expertise and facilitate a good working environment that prevents discrimination on the basis of age, gender or cultural and geographical background.

Petoro personnel have extensive experience from the petroleum industry and a high level of expertise. The individual employee is crucial to the company's deliveries and success, and the board places emphasis on ensuring that Petoro provides competitive terms and a stimulating working environment that attracts people with the right expertise and positive attitudes. Opportunities for professional and personal development will help retain, develop and attract skilled personnel.

Petoro had 64 employees at 31 December 2016, the same as the year before. Three staff members resigned during the year, one temporary position ended and four new appointments were made. No occupational accidents were recorded among Petoro's personnel in 2016.

Women accounted for 38 per cent of the total workforce in 2016, and 43 per cent of the company's directors and executive management. Petoro emphasises equal 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. Absence due to illness came to 1.7 per cent, compared with 1.8 per cent in 2015. Petoro has an inclusive workplace (IA) agreement, and utilises close follow-up and dialogue to promote good health and prevent absence due to illness.

Collaboration with the company's working environment committee (AMU) and works council (SAMU) lays an important foundation for a good working environment. These bodies also functioned well in 2016.

In light of the pension reform, Petoro changed its pension scheme as of 1 January 2016.

CORPORATE GOVERNANCE

The board emphasises 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 Regulations on Financial Management in Central Government and in standards for good corporate governance. The board observes the Norwegian State's principles for sound corporate governance as expressed in Meld. St. 27 2013-2014 "Et mangfoldig og verdiskapende eierskap" (Report No. 27 to the Storting (2013-2014) "Diverse and productive ownership") and those sections of the Norwegian Code of Practice for Corporate Governance regarded as relevant to Petoro's activities and the frameworks established by its form of organisation and ownership.

The management system is tailored to Petoro's distinctive nature, and enterprise management is based on management by objectives, under which objectives are established that support the company strategy. For further details see the separate section in the annual report.

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

CORPORATE SOCIAL RESPONSIBILITY (CSR)

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

Measures which ensure that Petoro discharges its CSR include ethical guidelines, openness regarding cash flows, the HSE declaration, climate policy and an HR policy that ensures diversity and equal opportunity. Petoro reports annual cash flows related to the SDFI portfolio to the Extractive Industries Transparency Initiative. Activity outside Norway is very limited. 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 2016 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 company's established frameworks.

Three internal audit projects were carried out in 2016; they assessed enterprise management and internal control, currency forecasts for Norges Bank and the handling of confidential information. The results were summarised in a report to the board describing the audit actions undertaken, findings, as well as proposed and implemented measures.

The internal audit projects in 2016 were conducted by PricewaterhouseCoopers (PwC), which has also been responsible for the annual audit of SDFI for the 2016 accounting year.

WORK OF THE BOARD

The board held 11 meetings in 2016. It has established a meeting and work plan with emphasis on addressing strategy, goals, budgets and interim results. The board is concerned with value creation from the overall portfolio, and ensuring that the state receives its rightful share and is not charged for 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 activities, which includes monitoring Statoil's duties under the marketing and sale instructions. It also monitors the company's overall risk picture. The board ensures that control systems have been established and that activities are conducted in accordance with the company's values base and guidelines on business ethics. A declaration has been drawn up by the board on 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, which also includes a review of company guidelines on business ethics and CSR, as well as instructions for the board. Directors must routinely report their ownership of shares or similar interest in other companies which could constitute or which could be perceived as constituting a conflict of interest with their position. They are furthermore required to report other relationships with licensees involved in petroleum activities on the NCS or with companies that supply licensees.

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, Brian Bjordal as deputy chair, Per Arvid Schøyen, Trude J H Fjeldstad and Per-Olaf Hustad as shareholder-elected directors, as well as Ove Skretting and Heidi I Nes 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 partially 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.

Petoro's share capital at 31 December 2016 was NOK 10 million, distributed among 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 in which the Norwegian government chooses to participate. The company's share capital at 31 December 2016 comprised NOK 2 million, distributed among 2 000 shares. It has no employees and has entered into a management agreement with Petoro AS.

NET INCOME AND ALLOCATIONS

Petoro AS maintains separate accounts for all transactions relating to participating interests in the joint ventures. Revenue and expenses from the portfolio are kept separate from day-to-day 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 responsible for the contractual obligations incurred by the companies. The consolidated accounts comprise the parent company and Petoro Iceland AS. Amounts related to intra-group transactions are eliminated in the consolidated accounts.

NOK 338.4 million (including VAT) was appropriated for ordinary operation of Petoro AS in 2016. Petoro AS also received a supplementary appropriation of NOK 5.3 million to cover external legal assistance and other technical assistance in ongoing legal disputes. The appropriation for Petoro Iceland was NOK 11.1 million.

Operating expenses in 2016 were in accordance with the board's approved budget, the company's appropriation and allocation letter. Petoro AS' net loss of NOK 4.5 million is due to planned high activity to realise the company's objectives and strategy. The group posted a net loss of NOK 4.1 million. The board proposes that the loss in Petoro AS is covered by a transfer from other equity, thus reducing other equity to NOK 7.3 million at 31 December 2016. The group's reserves of NOK 9.3 million comprise other equity in the parent company, NOK 2 million in grants from the Norwegian State related to establishing Petoro Iceland AS and accumulated results in the subsidiary.

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

PROSPECTS

It is presumed that the oil market will be reasonably balanced toward the end of 2017, presuming that OPEC and other countries implement their announced production cuts. Rising oil prices toward the end of 2016 contributed to a substantial increase in drilling activity for US shale oil. A moderate increase is expected in the production of shale oil in 2017. Continued growth in global demand for oil will support a rebalancing of the market.

In broad terms, demand in the European gas market in 2017 is expected to be on par with the previous year. A stable, high supply of Russian gas is also presumed. Global LNG capacity will increase further in 2017. Depending on developments in the global gas market, Europe may increasingly become the preferred market for LNG volumes, which will contribute to an additional increase in supply. The combination of ample gas supply and relatively flat gas demand indicates continued pressure on gas prices in 2017 as well.

The last two years have involved considerable efforts aimed at improving cash flows from fields over the short term, as well as profitability in new projects. Good results with considerable commercial impact have been achieved. The board would like to acknowledge the positive efforts expended in the industry as a whole and which have helped make the Norwegian Shelf more competitive. The board nevertheless concludes that there is a need for further improvement of profitability in order to bolster the competitiveness of future projects in the SDFI portfolio.

A number of exploration wells are planned in 2017 in licences awarded in the 23rd licensing round in the Barents Sea. The results from these wells will be crucial for further development in the far north, and most likely also for the addition of major new projects and new production over the long term.

Stavanger, 3 March 2017

Gunn Wærsted Chair	**Brian Bjordal** Deputy chair	**Trude J H Fjeldstad** Director
Per Arvid Schøyen Director		**Per-Olaf Hustad** Director
Ove Skretting Director elected by employees	**Heidi Iren Nes** Director elected by employees	**Grethe K Moen** President and CEO