Directors' report 2011

Petoro AS and the SDFI portfolio

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 this portfolio.

Net income for the portfolio in 2011[1] came to NOK 133.7 billion, compared with NOK 105.4 billion the year before. Total operating revenue was NOK 188.8 billion, compared with NOK 159.3 billion in 2010. This yielded a cash flow to the government of NOK 128.1 billion as against NOK 103.6 billion the year before. Total production averaged 1 016 000 barrels of oil equivalent per day (boe/d), which was six per cent lower than the 2010 figure of 1 080 000 boe/d. The net reserve addition of 601 million boe was the highest since the decision to develop Ormen Lange in 2003.

Income, revenues, costs and reserves

The net income of NOK 133.7 billion was up by 27 per cent from 2010. This substantial rise reflected higher oil and gas prices, but that effect was offset to some extent by lower production and higher costs. Overall oil and gas sales for the year averaged 1 083 000 boe/d, compared with 1 159 000 boe/d in 2010.[2] Further maturation of the portfolio meant that oil production in 2011 declined by 6.5 per cent from the year before. Gas output fell by five per cent from 2010.

Income before financial items came to NOK 135 billion. Net financial expenses of NOK 1.2 billion consisted mainly of calculated interest expenses on future removal liabilities for the SDFI.

Revenue for the year from dry gas sales totalled NOK 81.7 billion as against NOK 68 billion in 2010. Total gas sold fell by five per cent from 2010 to 37.4 billion standard cubic metres (scm), including sales of third-party volumes. That corresponds to 645 000 boe/d.[3] Troll accounted for 36 per cent of total gas revenue. The average gas price for the year was NOK 2.15 per scm, up 22 per cent from 2010.

Total revenue for the year from oil and natural gas liquids (NGL) was NOK 95.4 billion, compared with NOK 81 billion the year before. The sales volume totalled 160 million boe, or a daily average of 438 000 boe. The average oil price obtained for the year was NOK 632 per barrel, up by 31 per cent from 2010. In US dollars, the oil price averaged USD 114 per barrel, compared with USD 79 the year before.

Other revenues, which primarily comprise tariff earnings from Gassled, amounted to NOK 11.8 billion in 2011. That represented a rise of 15 per cent from the year before, reflecting a 7.358 percentage point increase in the SDFI's interest in Gassled during 2011 – as agreed when the latter was established – to 45.793 per cent.

Investment in 2011 came to NOK 21.5 billion, up by 15 per cent from 2010. The biggest spending in 2011 related to a high level of drilling activity on Troll, Gullfaks and Oseberg, the mid-north development on Ormen Lange and the development of a subsea compression facility on Åsgard. Investment was reduced by NOK 3.8 billion in connection with the swap agreement with Faroe Petroleum Norge AS. In addition come capitalised exploration costs, which brought total investment for 2011 to NOK 19.1 billion.

[1] All figures are based on the accounts compiled in accordance with the Norwegian Accounting Act.
[2] Sales of entitlement oil, NGL and gas in 2010 totalled 1 015 000 boe/d compared with 1 088 000 boe/d the year before.
[3] One billion scm of gas equals one million scm oe, which corresponds to about 17 200 boe per day (17.2 kboed).

The cost of operating fields, pipelines and land-based facilities was NOK 15.5 billion, on a par with 2010. Exploration-related costs amounted to NOK 2.3 billion, of which NOK 1.3 billion was capitalised as investment related to possible and confirmed discoveries, and NOK 1 billion was expensed as exploration costs for dry wells. Correspondingly, exploration expenses totalled NOK 2 billion in 2010, of which NOK 1.2 billion was expensed. A total of 14 exploration wells were completed during 2011, two more than the year before. Hydrocarbons totalling a recoverable volume for the SDFI of 320-550 million boe were proven in 10 wells, compared with some 30 million boe in 2010. The largest and most important discovery was Johan Sverdrup in production licence 265, but the Skrugard find in PL 532 also contributed substantial new volumes.

At 31 December 2011, the portfolio's expected remaining oil, condensate, NGL and gas reserves comprised 6 759 million boe – up by 221 million boe from the year before. Petoro reports the portfolio's expected reserves on the basis of categories 1-3 in the classification system used by the Norwegian Petroleum Directorate (NPD).

New reserves totalling 663 million boe were added to the SDFI in 2011. At the same time, reserves were downgraded for certain fields, making the net increase 601 million boe. This is the highest figure for new reserves since 2003, when the Ormen Lange development was sanctioned. The biggest contribution came from the decision to invest in compressors three and four for Troll. Substantial volumes were also contributed by subsea compression on Åsgard and by decisions on several projects involving standardised solutions for small commercially marginal fields which ensure fast-track development. The net reserve replacement rate for 2011 was 160 per cent, compared with 37 per cent the year before, and the average replacement rate for the portfolio over the past three years came to 49 per cent. The corresponding rate for 2008-10 was one per cent.

Book assets and equity
The book value of assets totalled NOK 226 billion at 31 December 2011. These assets mainly comprise operating facilities related to field installations, pipelines and land-based plants, as well as current debtors.

Equity at 31 December amounted to NOK 152 billion. Long-term liabilities totalled NOK 60.4 billion, of which NOK 57.9 billion related primarily to future removal liabilities. These liabilities are calculated in accordance with an established industry standard based on existing technology. Great uncertainty exists both over the removal estimates and over the timing of removals. Current liabilities, which comprise provision for costs incurred but not paid, were NOK 13.6 billion at 31 December.

Petoro served at 31 December as the licensee for the government's interests in 146 production licences and 13 joint ventures covering pipelines and terminals, including the interests in Mongstad Terminal DA and Vestprosess DA. It also managed the shares in Norsea Gas AS and Norpipe Oil AS. The number of holdings in production licences has increased by 74 per cent since the company was established.

Strategy for Petoro
The company's strategy falls into three parts, and is directed particularly at activities on mature oil fields. That is because these fields represent large assets in the portfolio, because taking decisions to secure these assets is time-critical, and because Petoro believes that they fail to receive the necessary attention from other licence partners.

Realise the potential in and close to large mature fields. Petoro's commitment to realising the potential in large mature fields is directed at extending the producing life of priority installations through the choice of technical solutions, efficient drainage methods and the completion of more wells per year. Its efforts will help to achieve a time-critical change in the way the fields are operated in coming years. The company will also work for integrated area solutions by prioritising selected installations for use as field centres, and achieve a timely phasing-in of discoveries.

Integrated and timely development of the gas value chain. As the largest participant in Gassled, Petoro plays a key role in the gas infrastructure. This role is expected to become more demanding, since production developments and the technical integrity of the facilities will require significant measures related to Gassled's processing plants in coming years. This has become even more challenging in view of the changed owner composition.

Developments in the European gas market have weakened the basis of the traditional business model for gas marketing and sales. Increased competition and transparency have challenged the strategy and role of the players. What happens in the global and European markets for natural gas in the future, and an understanding of these developments, will be crucial for realising the value potential of the SDFI's gas portfolio. Establishing a robust marketing and sales strategy for SDFI gas together with Statoil is a priority job. In accordance with the marketing and sales instruction, Statoil sells the government's petroleum together with its own petroleum and takes all decisions related to marketing and sales. The goal is to achieve the highest possible value for the petroleum belonging to Statoil and the government.

Safeguard asset values in new discoveries. Barents Sea South and Vøring stand out as the most important frontier areas in the portfolio. To ensure optimum development of the portfolio, Petoro's efforts in the time to come will concentrate on seeking business opportunities in Barents Sea South. On the basis of the Johan Sverdrup discovery, its commitment in this part of the strategy will also be to secure an acceptable development of and division of licensee interests in major North Sea finds.

Petoro's contribution to added value

In addition to safeguarding asset values, the board regards creating added value for the SDFI as an important job for the company. Results of the company's work are reflected in a wide range of activities which will contribute to substantial added value both in the immediate future and in the long run. An example of an important issue in 2011 was the work devoted to negotiating and implementing the licence swap agreement with Faroe Petroleum. Substantial efforts were also made to secure a decision on Åsgard subsea compression, including the outcome of negotiations on sharing the cost of this project between Åsgard and Mikkel, and on achieving a decision to utilise four rigs on Troll. Petoro also contributed to value added through further development on Draugen, including decisions on new wells and subsea pumping. Other examples include the efforts by Petoro which led to the incorporation of Visund South in Visund, updating the drainage strategy and extending the drilling period on Heidrun, and decisions on selected fast-track developments. The company participated in eight of these projects.

Business areas in the SDFI portfolio

Changes were made to the company's organisation with effect from February 2011 to ensure that the way its work is organised supports the new strategy and drives its realisation forward.

The *mature oil fields department* is responsible for developing the portfolio of mature oil fields and associated new discoveries, while the *gas fields/new developments department* deals with the gas fields and new developments as well as coordination of the company's exploration commitment. In cooperation with the marketing department, it will ensure a focus on the gas value chain and on maximising the value of the portfolio's gas resources. The *marketing department* is responsible for activities related to the oil and gas market and for following up the marketing and sales instruction.

The *mature oil fields* portfolio comprises 20 producing fields, with Gullfaks, Snorre, Heidrun, Oseberg, Grane, Draugen and Norne as the largest and most important. Snorre, Gullfaks and Heidrun have priority in the company's long-term efforts to secure changes on mature fields.

Total production from mature oil fields in 2011 averaged 291 000 boe/d. The output of liquids from the mature oil field portfolio fell by an annual average of 12 per cent over the past six years. The big mature fields are in a phase where production will continue to decline unless this trend is countered by additional volumes in the form of improved recovery and new discoveries. Liquids output from the fields in this business area amounted to 243 000 boe/d in 2011. Adjusted for the return of volume related to the Heidrun redetermination, production declined by 11 per cent from 2010. Challenges with high pressure and well integrity were faced on Gullfaks, and production was substantially lower than the year before. Problems with a number of risers on Snorre and Visund also caused output reductions.

Expenses for operating mature oil fields and facilities came to NOK 7.8 billion, down by seven per cent from 2010 when account is taken of the Heidrun redetermination. An important reason was that injection gas is no longer purchased for Grane.

Drilling planned wells on the large mature fields has been difficult. An important reason is that the drilling facilities are used to a great extent for downhole work to maintain existing wells. A total of 19 production and injection wells were completed in 2011. Analyses by Petoro show that two-three times the annual number of producers drilled in recent years will be required if the many remaining drilling targets in the mature fields are to be produced within the producing life of the installations.

Substantial reserves still remain in the existing fields, and work is under way on analysing various solutions which could ensure an optimum and more long-term development of Snorre, Gullfaks and Heidrun. The joint ventures are due to take many major investment decisions in coming years, which will contribute to improved recovery and extended producing life. Petoro worked in 2011 to ensure better reservoir understanding as the basis for the forthcoming decisions, to facilitate drilling more wells per year and to ensure the profitability of drilling targets. Increased drilling capacity is needed on the large mature fields, and the company has won approval for studying wellhead platforms as an alternative to subsea developments in the long-term plans for Gullfaks and Snorre.

Investment in the mature oil field portfolio totalled NOK 9.3 billion in 2011, up by 25 per cent from the year before when account is taken of the Heidrun redetermination. The increase relates particularly to new developments and major modifications.

The reserve addition for the fields in this portfolio amounted to 135 million boe. The biggest contributions related to the decisions on investing in seven small developments. Six of these form part of Statoil's portfolio of fast-track projects, with three expected to be on stream as early as 2012. Decisions were also taken on wells and subsea pumping for Draugen, and on a new drainage strategy and an extended drilling period on Heidrun. The swap agreement with Faroe Petroleum meant that four producing fields were removed from the portfolio and thereby helped to reduce reserves for mature fields, but will contribute additional reserves from Maria for gas fields/new developments in the longer term.

Discoveries are still being made near the large fields. Four exploration wells on Gullfaks yielded finds. Three of these were completed in 2011, with the last completed in early January 2012.

Gas fields/new developments embraces 12 producing fields, and is dominated by Troll. Ormen Lange, Åsgard and Kvitebjørn also produced substantial volumes of gas in 2011. Total output from the gas fields in 2011 averaged 726 000 boe/d, about one per cent higher than the year before. Production of liquids came to 197 000 boe/d, while gas sales amounted to 30.7 billion scm or an average of 529 000 boe/d. Expenses for operating fields and facilities in the business area came to NOK 6.9 billion, up by three per cent from 2010.

Petoro's commitment in 2011 was concentrated on the continued development of Troll, Åsgard, Ormen Lange and Snøhvit, development of Hild and work aimed at developing the major new Johan Sverdrup discovery in the North Sea. Investment came to NOK 12 billion, up by NOK 1 billion from the year before. Spending on development and production drilling accounted for about NOK 10 billion of the total.

Petoro worked to implement the strategy of making continuous use of four rigs on Troll and investing in compressors three and four, to be phased in at a point which provides the necessary flexibility for improved gas recovery. The company's commitment helped to ensure the adoption of subsea compression on Åsgard, and work was pursued on maturing a future subsea compression solution for Ormen Lange. A priority on Snøhvit was to develop the resource base and ensure increased capacity at Melkøya, either through an additional process train for liquefied natural gas (LNG) or a new gas pipeline. Petoro conducted studies of the sub-surface which support increased reserves in the Snøhvit area. A plan for development and operation of Hild was submitted to the government in January 2012.

The reserve addition for the gas fields was very high in 2011, at 466 million boe in all. The largest contributions were the decisions on compressors three and four for Troll and subsea compression on the Midgard reservoir in the Åsgard licence.

A total of 11 exploration and appraisal wells were completed in the gas fields/new developments business area during 2011. An additional well was under way at 31 December. A total of seven wells proved hydrocarbons, including five commercial discoveries. The biggest was Johan Sverdrup, but Skrugard and Havis – completed in January 2012 – in the Barents Sea also represented substantial discoveries. Johan Sverdrup extends over several production licences held by different joint ventures. Petoro is working to ensure good commercial solutions which safeguard the state's interests.

Petoro is the largest participant in the Gassled joint venture, which embraces gas infrastructure and terminals on or associated with the NCS. Day-to-day operation is handled by Gassco. Substantial changes occurred in Gassled's ownership structure during 2011 because several large oil companies, which ship considerable volumes of gas through the system, sold their holdings to financial investors. Petoro's holding was increased with effect from 1 January 2011 to 45.793 per cent, as agreed when Gassled was established. Priorities for Petoro in the time to come will be to ensure good corporate governance in Gassled and to establish good relations with the new owners and shippers. The SDFI received an income of NOK 11 million from Gassled during 2011, while investment and operating costs came to NOK 988 million and NOK 2.2 billion respectively. Regularity at Gassled's export points to the markets was 99.17 per cent, compared with 98.78 per cent in 2010.

Marketing and sale of the products

All oil and NGL from the SDFI portfolio is sold to Statoil. The latter is responsible for marketing all the 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 products achieve the highest possible overall value, and for ensuring an equitable division of total value creation. Petoro concentrates in this work on Statoil's marketing and sales strategy and risks, issues of great significance in value terms, matters of principle and questions relating to incentives.

After a period of relative stability in energy markets during 2010, volatility returned in 2011. Unrest in the Middle East and north Africa as well as debt problems in Europe and the USA led to substantial fluctuations in product prices during the year. The Brent Blend oil price varied between USD 93 and USD 126 per barrel, and achieved an average price of USD 114. Oil price changes in Norwegian kroner were somewhat higher because the USD exchange rate strengthened during the year from NOK 5.76 per USD to NOK 5.93.

Part of the gas sold to Europe is priced in accordance with market quotations which reflect the balance between supply and demand.

The average gas price for the SDFI portfolio in 2011 was NOK 2.15 per scm, compared with NOK 1.76 the year before. About 80 per cent of the SDFI's gas production was sold under long-term contracts at 1 January, with the rest sold in the spot market. Gas prices in the long-term contracts are primarily calculated in relation to the price of oil products and quotations in the gas market.

The rise in oil prices and continued plentiful supplies of gas in the market during 2011 again helped to maintain a significant differential between oil-indexed contract prices and spot prices for gas. This position led to pressure on the level of prices in the long-term contracts.

Petoro will work to ensure maximum value creation for the gas portfolio, including realisation of the value potential in the long-term sales contracts. The company is concerned to ensure that available gas is sold in the market at the highest possible price, and that the flexibility of the production plants and transport capacity is exploited to optimise deliveries.

Petoro also monitored and assured itself that petroleum sales to Statoil's own facilities are made at their market-based value. In addition, checks were made to ensure that the SDFI was being charged an equitable share of costs and received its equitable share of revenues.

Health, safety and the environment (HSE)
The serious incident frequency (SIF) per million working hours was 1.5, on a par with 2010. A total of 50 incidents were registered as serious, or an average of 2.8 incidents per installation included in the statistics. No fatalities were suffered in 2011 and, in line with the assessments of the Petroleum Safety Authority Norway (PSA), no incidents were recorded with the potential to become major accidents. Dropped objects and incidents related to mechanical handling continued to dominate the statistics. Nevertheless, a reduction in the number of dropped objects was registered in the 2009-11 period – from 192 in 2009 to 104 in 2011 for the NCS in total. This is a result of measures adopted by the industry.

Petoro gave priority in its HSE work during 2011 to establishing a common approach in the licences to identifying major accident risk, and for identifying and following up compensatory measures. This will initially be implemented in the Oseberg joint venture, with an action team drawn from ExxonMobil, ConocoPhillips, Total and Petoro.

The personal injury frequency came to 5.7, a slight increase from 2010.

Petoro participated in HSE management inspections during 2011 on selected fields and installations, including Snorre and the Kollsnes plant. The company works with the operators and the industry as a whole to achieve a reduction in personal injuries and serious incidents.

No large oil spills were registered from fields in the portfolio during 2011.

Attractive working environment and expertise
The individual Petoro employee is crucial to the company's delivery and success, and the board gives emphasis to ensuring that the company offers a stimulating working environment which attracts people with the right expertise and positive attitudes. Helping each employee to achieve the professional and personal development needed to attain the company's goals and secure good utilisation of its overall expertise is a management responsibility.

Opportunities for professional and personal development will help to retain, develop and attract good personnel. Learning and expertise development goals with associated plans are drawn up each year at company and individual level. The company took action in 2011 to strengthen its expertise on mature fields and in the gas value chain. A two-pronged development programme was also launched to strengthen relational competence. The aim is to enhance Petoro's ability to succeed with its goals and strategies.

Petoro's human resources policy aims to ensure diversity and equal opportunities, competence development and good work on HSE.

Petoro had 67 employees at 31 December 2011, compared with 69 a year earlier. Three staff left during 2011. The company has sought to strengthen its organisation through new recruitment in recent years, particularly of people with technical expertise, higher education and relevant experience. The labour market for such expertise is tight, and recruitment processes are time-consuming. Petoro expects to increase its staff to 70 during 2012.

Sickness absence came to 1.9 per cent, compared with 3.7 per cent in 2010. This represents a very positive result, and the reduction from 2010 reflects lower long-term sick leave. Petoro has an inclusive workplace (IA) agreement, and gives weight to close follow-up of and dialogue with employees on sick leave, as well as making arrangements to ensure that such absences are as short as possible.

Collaboration with the company's working environment committee (AMU) and works council (Samu) lays an important basis for achieving a good working environment in the company. Work in these bodies again functioned well in 2011.

Social responsibility
Petoro's management of substantial assets on behalf of the Norwegian government calls for good corporate governance which fulfils the expectations of its stakeholders and society at large. The company's operations are related to the NCS and have international exposure. The board would emphasise that Petoro's corporate social responsibility (CSR) forms an integral part of its activities and strategies. This is reflected in part through the company's values. Measures which ensure that Petoro discharges its CSR include the following.

Ethical guidelines: The company has drawn up guidelines on business ethics, which are publicly available. Their purpose is to clarify principles which govern the company's commercial operations and employee behaviour. The ethical guidelines are reviewed once a year with all the employees in the company. All employees in 2011 signed the company's ethical guidelines, which cover such considerations as the duty of confidentiality, possible conflicts of interest and issues related to the receipt of gifts and services. Petoro has established data and information and communication technology (ICT) security requirements for its operations. Its information systems and data are secured against unauthorised access. The consequences of breaching Petoro's guidelines on business ethics are covered in a separate section.

Openness on money flows and anti-corruption work. Petoro does not accept corruption or other malpractice. As an important anti-corruption measure, employees are not permitted to receive remuneration from others. Petoro reports money flows related to the SDFI portfolio on an annual basis to the extractive industries transparency initiative (EITI). Details of the remuneration of directors and senior executives are provided in a separate note to the accounts for Petoro AS.

HSE declaration. Through its HSE declaration, Petoro has a common goal of creating a good physical and mental working environment for all employees. The board encourages the company's employees to raise ethical issues and to report any breaches of the regulations they encounter. The internal audit function is an independent whistleblowing channel with the right and duty to report on to the board. No cases of whistleblowing were recorded in 2011.

Equal opportunities. Women accounted for 36 per cent of the total workforce in 2011, compared with 33 per cent the year before, and for 42 and 25 per cent of the company's directors and executive management respectively. Petoro gives weight to equality between the genders in terms of opportunities for professional and personal development, pay and promotion. The company facilitates a flexible customising of working hours. When determining pay and in pay negotiations, Petoro is conscious that men and women must be treated equally. No systematic or significant differences exist between male and female pay in the company.

Diversity. Petoro has recruited a number of employees with differing cultural and ethnic backgrounds. The company offers language facilitation to new recruits, and Norwegian lessons were provided during 2011 when a requirement was identified.

Natural environment. The NCS has a good record for environmental impacts compared with other petroleum provinces. Further improvement is nevertheless the goal. Petoro is concerned to ensure that power from shore is assessed for new field developments and major conversions, and that a decision is based on technically feasible solutions at an acceptable abatement cost. The company has followed up this subject in the projects on compressors three and four for Troll and on developing Hild. Both will be supplied with electricity through submarine cables from Kollsnes, and thereby help to reduce carbon emissions from the increase in production. Power from shore is also a key issue in the assessment of capacity expansion on Snøhvit. One condition for increased use of power from shore is sufficient capacity in the electricity grid on land.

The company contributes to creating environmentally conscious attitudes among all its employees. Waste sorting was adopted in 2011, and incentives were established to increase use of public and environment-friendly transport. The company gives emphasis to efficient ICT solutions and good communication systems, with opportunities to replace physical meetings with videoconferencing.

Petoro reports emissions to the air and discharges to water from the portfolio in a separate chapter of its external annual report on the natural environment, based on figures obtained from the operators. No significant emissions to the air or discharges to the sea occurred from the SDFI portfolio during 2011.

Research and development
The oil companies devote some NOK 3 billion per year to petroleum-related research and development (R&D), and the supplies industry about NOK 1 billion. Through its interests in production licences, Petoro contributes to R&D by meeting its share of these costs in accordance with its participatory interest in the production licences, where the funds are managed by the respective operators. This amounts to more than NOK 500 million per annum.

Qualifying new technological solutions for field application represents a major challenge for the oil industry, including on the NCS. Many initiatives on the borderline between technology development and qualification are accordingly financed directly through projects and in day-to-day operation. The costs are carried on the investment budgets of the joint ventures – through development or well drilling, for example. Petoro has worked for a number of years to secure faster adoption of technological opportunities. Its commitment in 2011 focused particularly on the company's own specialist work and active efforts to achieve a decision on a pilot project for advanced water injection on Heidrun, to develop the decision base for the final investment decision concerning subsea compression on Åsgard, and to follow up the subsea compression option on Ormen Lange. The decision on subsea compression on Åsgard was the result of five years of purposeful technological development in the Åsgard and Ormen Lange joint ventures.

Corporate governance
The board gives weight to good governance to ensure that the SDFI portfolio is managed in a way which maximises long-term value creation. That includes following up CSR as specified in White Paper no 13 (2010-2011) on active ownership – Norwegian state ownership in a global economy. The company's management system is based on the Norwegian code of practice for corporate governance to the extent that the code's recommendations are relevant to Petoro's business and the frameworks established by the company's form of organisation and ownership. Further developed and implemented in 2010-11, the management system contributes to maximising value creation for the state by concentrating attention at all times on the attainment of targets by the company and on the risk picture.

Petoro seeks a corporate culture characterised by commitment and vigour within a good internal control regime. Its values base and ethics are embedded in its values and guidelines on business ethics.

Work of the board
The board held 12 meetings in 2011. An annual meeting and work plan has been established for the board, with the emphasis on the consideration of strategy, goals, budgets and interim results. The board is concerned with overall 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. A key instrument used by the board to monitor performance is measuring against established goals (balanced scorecards).

The board considers major investment decisions in the portfolio as well as following up and considering the commercial business, including monitoring Statoil's duties under the marketing and sales 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.

Instructions issued by the board for its own work and that of the chief executive include ensuring the discharge of CSR in line with the company's duties and mandate. The board has chosen to organise preparatory work related to 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.

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. The board also conducts a study trip during the year, either in Norway or in a country relevant to Petoro as the manager of the state's petroleum interests.

Petoro's board comprises Gunnar Berge as chair, Hilde Myrberg as deputy chair, Mari Thjømøe, Per Arvid Schøyen and Nils-Henrik M von der Fehr as the other shareholder-elected directors, and Line Geheb and Erik Aarrestad as directors elected by and from among the employees.

Risk management and internal control
The board conducted an assessment of the risk picture in 2011 on the basis of the approved strategy, and set targets for the coming year. Compensatory measures were identified for the biggest risks Petoro has an opportunity to influence through the frameworks available to it. The most important identified risks relate to the failure of operators and partners to give priority to long-term development of the large mature fields, a lack of profitable solutions for securing sufficient wells, and the inability of the company to win approval in the licences for its commitment to Snorre, Gullfaks and Heidrun. A risk also exists that the SDFI's post-unitisation interest in the new Johan Sverdrup discovery will fail to reflect Petoro's view on the division of the assets. The biggest risk in the marketing and sales area involves substantial erosion in value as a result of price revisions, renegotiations and structural changes in the gas market.

Operational risk is mainly managed at field level within the various business areas and within the joint ventures. Principles for risk management in Petoro build on the internationally recognised Coso/ERM framework for internal control, and on in-house expertise.

Prospects
Considerable changes are taking place on the NCS, and the future of the SDFI portfolio depends on developing the mature oil fields and dealing with the gas market, and on access to new exploration acreage. The bulk of remaining reserves on the NCS still lie in existing fields, even after the welcome major discoveries in 2011. That underlines the significance of these producers, and it is accordingly important that the joint ventures for the big mature fields are able to realise this potential.

Increased reserves and new technology have extended the producing life of several large mature fields, but oil output is still declining significantly every year. At the same time, so few production wells are being drilled that it could be difficult to achieve planned recovery before the fields must be shut in. A substantial commitment is accordingly needed from both companies and government to achieve the necessary changes on mature fields. The board would emphasise the importance of Petoro strengthening its efforts to ensure that the operators and other partners give priority to reserves in as well as work on and investment in the mature fields on the NCS.

Statoil is still the dominant player on the NCS and operates about 80 per cent of production from the SDFI portfolio. This means that the choices made by this company have great significance for the further development of the NCS and the SDFI.

Although substantial discoveries were made in 2011 with the potential for stand-alone production, developments on the NCS are expected to be characterised by many small discoveries combined with declining production from mature fields. Exploiting tested technology and standardised solutions will be important in achieving profitable development of these small finds. The board takes the view that Petoro will continue to play an important role in finding good solutions for these challenges.

Furthermore, the board is concerned about the substantial added value offered by efficient operation of fields on the NCS. It is important that Petoro contributes to achieving the goal of efficient and profitable operation by following up spending on selected producing fields which face major cost challenges.

Petoro has ambitious goals for its role as a partner and manager of the SDFI portfolio on the NCS. It aims to contribute to enhanced value creation and gives priority to work on the areas when the value potential and its ability to exert influence are greatest. The company achieves this through purposeful use of the funds allocated to it for independent studies and assessments, and to support and challenge the operators. Where commercial matters are concerned, Petoro must safeguard the government's interests in competition with the priorities of other companies. It fulfils this role within the appropriations provided through a purposeful build-up of its own expertise and capacity, and by setting good priorities. It is very important that the company succeeds in retaining and attracting an appropriate level of expertise in an overheated market.

Environmental challenges on the NCS and what these will mean for the development of the portfolio are a matter of concern for the board. Great uncertainty exists over which climate policy instruments will be applied to the petroleum sector and the consequences these will have for the SDFI portfolio.

The board expects oil prices to be relatively high but volatile during 2012. Prices are balanced between uncertainty on the supply side related to relatively low reserve capacity and persistent unrest in the Middle East, and uncertainty over demand because of world economic trends. Output from the SDFI's portfolio is not expected to increase in coming years, but the shift from oil to gas will continue.

Structural market changes and increased supplies from the USA have reduced price levels for gas relative to those for oil. The economic position in Europe is expected to reduce demand for gas in this market compared with earlier estimates. Great uncertainty also prevails about the supply of LNG to Europe, because this depends on demand in Asia. Viewed overall, the outlook for the balance between supply and demand for gas in Europe is very uncertain. In addition, considerable uncertainty prevails about the longer-term role of gas in tomorrow's European energy picture as a result of current processes within EU energy and climate policies.

Petoro AS – share capital and shareholder

The company's share capital at 31 December 2011 was NOK 10 million, divided between 10 000 shares. All the shares are owned by the Ministry of Petroleum and Energy on behalf of the Norwegian government. Petoro's business office is in Stavanger.

Petoro AS – net income and allocations

Administration of the portfolio by Petoro is subject to the accounting regulations for the government. The company maintains separate accounts for all transactions relating to the participatory interests, so that revenue and expenses for the portfolio are kept apart from operation of the company. Cash flows from the portfolio are transferred to the central government's own accounts with the Bank of Norway. The company prepares separate annual accounts for the SDFI, with an overview of the participatory interests managed by Petoro and associated resource accounting. 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). All amounts cited in this directors' report are based on NGAAP.

Petoro's operating revenue takes the form of a contribution from the government, which is directly liable for the commitments accepted by the company under contract or in other forms. The government contribution for 2011 was NOK 264 million, compared with NOK 260 million the year before. Since this sum includes VAT, disposable revenue was NOK 211.2 million as against NOK 208 million in 2010. Recorded income, including financial income, for 2011 was NOK 221.6 million, compared with NOK 216.6 million the year before.

Operating expenses were NOK 228 million for the year, compared with NOK 216.5 million in 2010. These expenses related primarily to payroll and administration expenses and to the purchase of external services. The purchase of leading-edge expertise relating to supervision of production licences in the SDFI portfolio accounts for a substantial proportion of the company's operating expenses. The company carried out in-depth studies of the Gullfaks, Heidrun and Snorre fields in 2011. Costs for studies and leading-edge expertise were somewhat lower than in 2010, in part because of difficulties in securing consultants in the market.

The board devoted attention in 2011 to the company's overall resource position. Further use of resources directed at mature fields and critical activities will be given priority, but kept within available disposal funds.

The net loss after net financial income came to NOK 7 million. The board proposes that this loss be covered from other equity. The company's equity position is good, and it has little exposure to financial risk. Its non-restricted equity totalled NOK 15.9 million at 31 December after coverage of the net loss.

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 under the assumption that the company is a going concern.

Stavanger, 22 February 2012

Gunnar Berge Chair	Hilde Myrberg Deputy chair	Nils-Henrik M von der Fehr Director
Per Arvid Schøyen Director		Mari Thjømøe Director
Erik Aarrestad Director*	Line Geheb Director*	Kjell Pedersen President and CEO

*Elected by the employees