

EXPLANATORY NOTES ON THE PARLIAMENTARY BILL ON THE FIRST LICENSING ROUND

GENERAL NOTES

1. Introduction

In conformity with section 7(2) of Act No. 31 of 16 March 1998 on Hydrocarbon Activities (the Hydrocarbon Activities Act), the objective of the Bill is to define the areas to be offered for licensing and to establish the general terms and conditions on which licenses will be granted in the first Licensing Round for the exploration for and production of hydrocarbons.

The Hydrocarbon Activities Act authorises the Faroese Minister of Petroleum to issue licenses for the exploration for and production of hydrocarbons in specific areas and on terms and conditions to be specified. In accordance with the Hydrocarbon Activities Act, licenses may be issued only after licensing rounds have been held. Such licensing rounds can be initiated upon the adoption of a Parliamentary Act defining the areas to be comprised by the invitation and the general terms and conditions on which licenses will be granted. Besides indicating the areas offered for licensing and setting out the general terms and conditions, the explanatory notes to such Parliamentary Bills on licensing rounds must include an assessment of the impact of the hydrocarbon activities on a number of areas of special importance to the Faroese community. When the areas offered for licensing and the general licensing conditions have been set out in a Parliamentary Act, the Minister of Petroleum will be responsible for carrying out the licensing round and granting licenses.

Important events leading up to the first licensing round include the agreement made between the Faroese Home Rule authorities and the Danish government in 1992 on the transfer of legislative and administrative competence concerning “mineral resources in the subsoil” to the Faroese Home Rule authorities, as well as the resolution adopted by the Faroese Parliament on 24 September 1993. This resolution stated that a first licensing round should be held for the purpose of granting licenses for exploration for and production of hydrocarbons, once the geological composition and geographical delimitation of the continental shelf had been clarified.

Since this resolution was adopted by Parliament in 1993, extensive seismic surveys of the Faroese continental shelf have been performed. In addition, other investigations have been carried out, including an onshore stratigraphic well at Lopra, in order to accumulate geological data. Combined with surveys and discoveries made on the UK continental shelf, these investigations have given the Faroese authorities a detailed picture of the composition and prospectivity of the Faroese continental shelf, indicating that large parts of the continental shelf are not mature for actual exploration. However, other parts of the continental shelf, especially to the southeast of the Faroe Islands, seem to afford better opportunities for exploration and finding oil. On the whole, the area offered for licensing must be considered a frontier area with considerable exploration risks.

The continental shelf boundary between the Faroe Islands and the United Kingdom was defined in the agreement signed by the parties in Tórshavn on 18 May 1999. The agreement came into force on 21 July 1999.

The Minister of Petroleum is of the opinion that satisfactory answers have been given to the questions that Parliament wished to clarify in 1993 before holding a first licensing round, and therefore deems it appropriate to initiate the first licensing round now.

In offering areas for licensing, the hope is to establish whether the Faroese area has sufficient oil and gas deposits to warrant production. Exploration will hopefully result in the establishment of an oil industry that, together with the fishing industry, can help secure the livelihood of future generations in the Faroe Islands.

In awarding licenses for exploration and production of hydrocarbons, great weight will be attached to the potential licensees' exploratory commitments, as these commitments reflect the minimum work to be carried out by a licensee to locate hydrocarbon reserves in the area comprised by its license. In addition to the exploratory commitments, it is vital that Faroese trade and industry are given an opportunity to take part in the activities in order to improve their skills and international competitiveness for the benefit of the Faroese community as a whole.

In planning the licensing round and supervising the activities carried out under the licenses granted, the focus of the Ministry of Petroleum throughout will be the objective of the Hydrocarbon Activities Act, i.e. "to provide for prudent and appropriate exploration and exploitation of hydrocarbon resources for the benefit of the Faroese economy and employment opportunities, and to plan the activities with due consideration given to fishing, navigation, the environment, nature and other interests of society."

Not all the terms to which oil companies will have to conform when operating in the Faroe Islands are part of this Bill. This autumn, the Minister of Finance will present a Bill in Parliament on amendments to the Act on Hydrocarbon Taxation, introducing a special hydrocarbon tax. The special tax contemplated is described in chapter 4.3.4 below.

The Bill has been prepared by the Ministry of Petroleum and a group of advisers set up by the Minister of Petroleum in June this year. In addition, the Ministry of Petroleum has consulted internationally recognised consultants in the hydrocarbon industry.

Section 44 of the Act on Hydrocarbon Activities stipulates that every other year, a statement must be submitted to Parliament which is to form the basis of a debate on oil policy. The first statement is to be submitted in 1999. The reading of the Bill on the First Licensing Round will replace this debate. The Minister of Petroleum intends to submit a report on oil-related matters to Parliament when the exploration licenses have been granted next summer.

2. Summary of the main licensing terms

The area proposed to be comprised by the first licensing round is contiguous and covers approx. 14,000 square kilometres, and is situated to the east and the southeast of the Faroe Islands. The reasons for

licensing this area are to focus exploration activities on areas where the prospects of finding oil are considered optimal, and thus to increase the possibilities of finding oil as soon as possible. This area is also considered to give the oil companies an opportunity to investigate alternative parts of the continental shelf.

Exploration opportunities differ substantially in the various parts of the Faroese continental shelf. Consequently, two types of exploration license are envisaged, for terms of six and nine years. The work commitments imposed on the licensee should reflect the prospects of finding oil in the particular license area.

Applicants must pay an application fee when applying for exploration and production licenses. It is furthermore proposed that, once an exploration and production license has been obtained, applicants must pay an annual rental based on the size of the area comprised by the license.

Introduction of a royalty is proposed for all quantities of hydrocarbons produced. The royalty is to be calculated as 2% of the landed value of the production. It is also proposed that the corporation tax on production income is fixed at 27%. It is furthermore considered appropriate for oil companies to pay a special hydrocarbon income tax. The marginal tax rate should not exceed approx. 55%.

Considering the competitive situation with regard to hydrocarbon exploration, as well as other factors, the establishment of a national Faroese oil company is not recommended. Moreover, the objectives that are usually achieved through a national oil company can be achieved by other means, including legislative measures and licensing conditions.

It is proposed that obligations are imposed upon the licensees which ensure that Faroese companies are provided with genuine opportunities, in competition with other companies, to obtain general contracts and subcontracts and to provide goods and services. Furthermore, licensees will be obliged to promote the conclusion of contracts between Faroese and foreign companies to build up the competence and technological know-how of Faroese companies. These obligations are introduced in order to improve the competitiveness of Faroese industry and to promote the entry of Faroese companies into new markets.

3. The macro environment and the effect on the competitive position of the Faroe Islands

Lately, the oil industry has had to contend with fairly unstable conditions. Oil prices have fluctuated, and several oil companies have either been taken over or have merged with competitors.

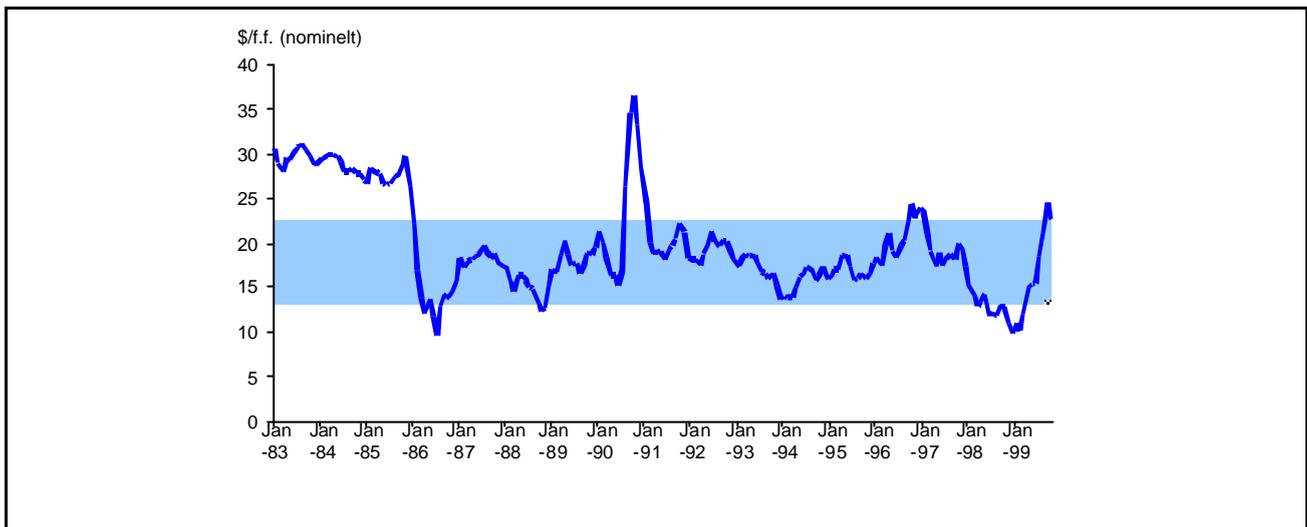
Chapter 2 of the report "Preparation for Oil Exploration" (pp. 63 ff.) outlined the status of the economic conditions of the oil industry, to which reference is made below. This area has undergone major changes in the past two years. It is therefore considered appropriate to discuss briefly such topics as oil prices, the market for gas and the current strategies of the oil industry. The effect of the macro environment on the competitive position of the Faroe Islands is also dealt with briefly.

3.1. Oil prices

Oil prices have a major impact on the activities of oil companies as well as on their propensity to invest. The Brent oil price has fluctuated considerably in the past year. In January 1999, the price was below \$10 per barrel, but in October it reached almost \$25.

The chart below shows movements in the Brent oil price from the beginning of 1983 until October 1999.

Brent oil price



In the past ten years, oil has generally traded at prices ranging from \$14/barrel to \$23/barrel. A number of factors influence supply and demand, and thus the price of oil. The demand for oil is especially influenced by economic conditions in major industrialised countries, while the supply is controlled primarily by the OPEC countries.

Generally, production from a field is discontinued when cost of production exceeds the price of oil, rendering production from these fields non-commercial. At the same time, the revenue earned by the OPEC countries does not meet the revenue requirements of these countries. Consequently, the OPEC countries impose production quotas (such a quota is currently operative) to limit the supply, and, in turn, raise the price of oil. When the price of oil exceeds the cost of production, more suppliers enter the market and, at the same time, the high oil price may tempt some OPEC countries to produce more than their share of the quota. This leads to an increase in the accumulated production of oil, which causes the price to fall.

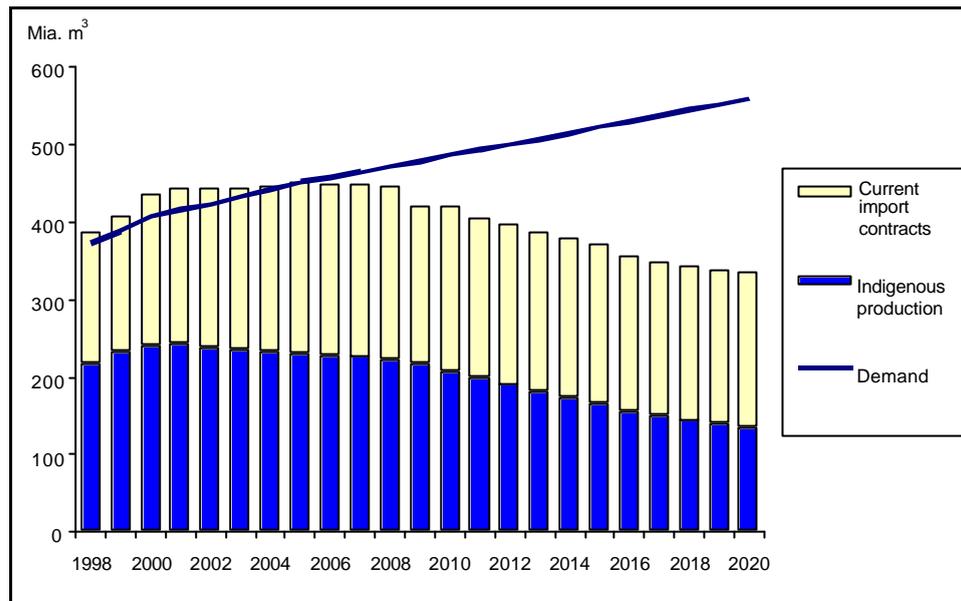
It is the view of observers that last winter's low oil price was an exception, but it is also estimated that the current oil price of more than \$21 will not prevail in the long term. It is believed that most oil companies base their current forecasts on a Brent oil price of between \$14/barrel and \$18/barrel for the year 2000.

3.2. The gas market

The outlook for the gas market in Europe could have major significance for a future hydrocarbon industry in the Faroe Islands if gas is found in the Faroese subsoil. The European gas market is complex, and only a few main issues will be addressed here.

Any gas produced on the Faroese continental shelf will most probably be landed in the UK. Forecasts predict that the UK will be a net importer of gas within a few years. However, new pipelines between the UK and continental Europe will eventually lead to an integration of the UK and continental European markets.

The chart below shows the production of gas, current imports and the expected demand for gas in the European Union.



The EU has significant gas reserves, the main producers being the Netherlands and the UK. Imports stem principally from Norway (a member of the EEA) and from Russia and Algeria.

It is believed that the large supply of gas will weaken the European gas market during the next few years. Later, demand will outstrip supply, but the increased demand for gas can presumably be met by increased production/imports from gas fields already discovered, but as yet undeveloped (e.g. Norwegian fields), and which are situated close to existing pipelines. In the long term (around the year 2020), the EU could be importing around 75% of its gas supplies.

Some companies have conducted a study to examine the possibilities of producing gas from the fields west of Shetland. The findings of this study are confidential, but are believed to reveal that insufficient gas has been found to date to justify the substantial investments needed to produce and market the gas.

If it is established that gas is more likely to be discovered in the Faroese subsoil than oil, this may reduce the oil companies' interest in the Faroese area in the short term. However, in the longer term, this will not necessarily affect the attractiveness of the area.

3.3. The oil companies

As mentioned in chapter 3.1 above, the oil price has a considerable impact on the strategies adopted by oil companies. Oil companies and their shareholders are influenced by current oil prices, but also by forecasts about the expected development of the oil price. Because of fluctuating oil prices, oil companies have been forced to adapt their strategies to changes in the macro environment.

When oil prices remained high in the mid-1990s, the strategy of most oil companies was to expand "naturally", i.e. through an increase in production. During that period, the companies stepped up their exploration expenditure in the hope of making new discoveries to compensate for the depleted oil reserves caused by increased production. When the oil price plummeted in 1998/99, new and extensive cost-reducing measures were initiated, with the heaviest cuts being made in exploration costs. Now that the oil price has recovered, the amounts spent on exploration seem to have increased. However, oil companies seem to be focusing on oil fields which they believe will yield shareholders a high rate of return. One of the goals of the recent mergers is for a smaller staff to administer larger sums, resulting in a relative reduction of operating expenses.

The Faroe Islands must be considered a frontier area in terms of hydrocarbon exploration. It is fairly uncertain whether oil will be discovered, and, furthermore, the Faroe Islands are considered to be a high-cost area. The oil companies expected to apply for licenses in the Faroese area are major international oil companies and include some of the super majors.

It should be borne in mind that these companies explore for oil throughout the world and that they demand a high rate of return on all their investments. In recent years, the general trend in the oil industry has been for investment opportunities to exceed the oil companies' investment capital. This means that potential investments on the Faroese continental shelf will be carefully compared with opportunities offered in other areas. The competition facing the Faroe Islands stems principally from licensing rounds in neighbouring countries.

It is therefore necessary for the terms and conditions regulating activities on the Faroese continental shelf to be drafted in such a way that they can be considered competitive compared to other countries with approximately the same prospectivity as that of the Faroese area. In this connection, it should be noted that the proposed charges payable by the companies in the exploration phase, e.g., application fees, signature bonus, area rental, have been reduced compared to the initial intentions. The intense competition from other countries is among the factors which have led to the conclusion that it is not considered advisable to introduce a "carried" interest for a national oil company in the license terms (see chapter 4.5).

The competitive situation will also affect the design of the special hydrocarbon tax, even if that tax will not be a burden upon the oil companies in the exploration phase, as it is connected to profits from production. Therefore it is seen as necessary to design the special hydrocarbon tax, see chapter 4.3.4, in such a way that it will only come into effect when the investment has given a substantial return.

4. Main elements of the first licensing round

Below, the main elements of the first licensing round will be discussed. Topics covered include areas offered for licensing, exploration conditions, financial aspects and business policy conditions. Chapter 4.7

briefly addresses a number of other general licensing conditions. Issues relating to a national oil company are discussed in chapter 4.5, including how the objectives normally pursued by a national oil company can be achieved by other means.

4.1. Areas offered for licensing

The area proposed to be comprised by the first licensing round covers approx. 14,000 square kilometres, divided into 56 whole blocks and 26 part-blocks. It is a contiguous area to the east and southeast of the Faroe Islands, approx. 25 – 92 nautical miles (46 – 170 km) off the coast, on the outer parts of the Faroe Platform, following the slope leading to the Shetland Channel. Closest to shore, the depth is about 250 metres (130 fathoms), but in the channel the depth increases to approx. 1,400 metres (750 fathoms). To the north, the area extends to 62°N; to the northwest, the area zigzags along several whole blocks from 62° N / 4° W to 61°20' N / 5°48' W; to the west, the area extends to 5° 48' W, and to the east and the southeast, the area extends to the UK continental shelf boundary (see map in Schedule A). All the part-blocks are located along this boundary.

The reasons for offering this area for licensing are:

- to focus exploration activities on areas where the possibilities of finding oil are considered optimal, and thus to increase the chances of finding oil as early as possible;
- to test various exploration models, so that exploration will not be limited to areas and geological environments which the industry currently finds most prospective (and thus to examine the possibilities of finding oil elsewhere);
- to encourage the oil industry to continue taking on technical challenges, and thus in the long term to evaluate the hydrocarbon prospectivity in the entire Faroese area; and
- to select the area offered for licensing and to draw up the licensing conditions so that this framework, combined with the knowledge and results achieved in the course of exploration, can lead to the maturing of other areas for future licensing rounds.

In addition, it is important to bear in mind that only a limited number of oil companies are expected to possess the necessary know-how, expertise, ability and financial capacity to efficiently explore the demanding Faroese area. The financial and human resources which the oil companies can allocate to the Faroese area are limited, as the companies also have to concentrate on their other operations in neighbouring countries, some of which require the same human resources. In addition, only a few drilling rigs can operate in deep waters, a factor which will limit the scope of drilling activity.

The recommendation to offer this area for licensing is based on the above considerations and requirements, as it is expected to lead to a future activity level which will satisfy national expectations. Under some of the licenses, exploration wells are expected to be drilled, while in other parts of the license area, it is expected that the initial activities carried out during the first three years or so will consist of other exploratory work, such as seismic surveys. Experience from neighbouring countries shows that licenses are in fact only

granted for parts of the entire area offered for licensing, mainly because some of the blocks are considered less attractive and because some of the applicants do not meet the stipulated requirements. Pursuant to section 7(3) of the Act on Hydrocarbon Activities, the Minister of Petroleum may decide not to grant some of the applications. Moreover, it may be advisable not to grant exploration licenses for some blocks, unless the applications are particularly qualified, and to reserve such blocks for future licensing rounds.

Future license areas could consequently cover blocks included in the first licensing round which remain unlicensed or which are relinquished to the authorities, cf. chapter 4.2 below. Areas which border on the area currently offered for licensing as well as other areas, such as the Faroe Bank Channel, may also form part of future licensing rounds. The results of exploration activities following from the first licensing round are also expected to provide important new knowledge about areas not covered by licenses granted in the first round. This knowledge will be vital to the preparation of future licensing rounds.

4.2. Exploration conditions

Our neighbouring countries normally grant exploration licenses for a term of six years in areas with relatively good technical conditions for oil and gas exploration and for which good and detailed geological data are available. A six-year term is considered sufficient to allow oil companies to complete the agreed work programme, which often includes the drilling of one or more wells, and to obtain the necessary knowledge to determine whether further exploration is required. Depending on the results, the licensee can apply for an extension of the license term or relinquish the area. In more challenging areas, the exploration license can be granted for a longer term.

The area situated to the far southeast on the Faroese continental shelf differs from the other areas in that:

- the area is close to several oil fields on the UK side of the boundary, two of which are producing fields. Geologically, the sedimentary basin with the reservoir interval extends into the Faroese area in the southeastern part of quadrants 6004 and 6005. Consequently, the oil industry has shown great interest in this part of the Faroese area and has high expectations of finding hydrocarbon deposits;
- the basalt cover in the area is very limited or absent. Therefore the possibilities of detailed geological mapping in the area are good;
- in recent years, detailed seismic data have been collected in the area. Consequently, the oil companies have had the opportunity, even before licenses are granted in the first licensing round, to map the geology in detail, including structures and potential reservoir rocks which are considered likely prospects. Thus, limited prospecting activity is required before the first exploration wells can be drilled, and preparations for drilling operations can be initiated shortly after the licenses have been granted.

Six-year licenses are considered appropriate for some parts of the license area, cf. clause 5(1), alternative 1, of the Model License. This applies in particular to the area to the far southeast, but may also apply to other parts of the license area, especially the area along the border leading through the Shetland Channel, which has limited or no basalt cover, and for which extensive data are available even before licenses are granted.

Other parts of the license area are covered by thick basalt layers, and the data available are not as comprehensive. This area will require thorough mapping before the first wells can be drilled. According to clause 5(1), alternative 2, in the Model License, licenses can be granted for nine years, allowing the companies to carry out various preliminary surveys and prospecting activities during the first three years of the nine-year term.

4.2.1. Work programme

Great importance is attached to the exploration commitments when licenses are granted. These commitments are specified in the work programme drawn up prior to the granting of licenses; see clause 4(1) of the Model License.

In view of the relatively accurate investigation and detailed mapping of parts of the area offered for licensing, the six-year licenses will generally impose a commitment on the licensee to drill one or more exploration wells in addition to other exploratory activities. In some cases, additional drilling requirements may be included in the license terms which will be made conditional on the results obtained from the first well(s) drilled under the work programme.

The nine-year license will incorporate a work programme for the first three years. Later, a new work programme will be prepared for the remaining six years of the exploration term. This second programme will reflect the results and expectations following from the first investigations. The first work programme is expected to cover seismic and other exploratory commitments, while the programme for the remaining six-year term is expected to provide for the drilling of one or more exploration wells.

4.2.2. Size of license areas and relinquishment of acreage

The extensive knowledge and keen interest in exploring parts of the area offered for licensing indicate that there will be a basis for granting six-year licenses which individually will cover relatively small areas, as the oil companies are expected to compete for licenses to explore particular prospects that they believe they can identify on the basis of the data currently available. Individual licenses which are granted in accordance with clause 5(1), alternative 1, of the Model License are therefore expected to cover an area of approx. 200 to 600 square kilometres corresponding to the size of 1 to 3 blocks.

Licenses granted in pursuance of clause 5(1), alternative 2, of the Model License will have a term of nine years and are expected to comprise areas which attract less exploration interest and for which less data are available. They are likely to include larger areas, up to 1,000 to 2,000 square kilometres, corresponding to the size of 5-6 blocks. When the work programme is prepared for the second six-year term, the licensee may be required to relinquish parts of its license area before the six-year term begins, or later. This depends on the agreed work programme and the experience gained from the exploration activities. Licensees undertaking demanding exploration commitments can expect to keep larger parts of their original license area.

As a main rule, the work programme for the second six-year period will only be approved if it includes a commitment to drill at least one exploration well. If the parties fail to agree on the work programme and the areas to be relinquished, the license will be revoked and the entire acreage must be surrendered to the authorities.

4.3. Fiscal and financial aspects

The financial commitments imposed on the licensees comprise direct fiscal charges, as well as the indirect requirement that their activities be organised to yield revenue for and stimulate business activity in the Faroe Islands.

The direct fiscal charges are levies and taxes, etc., the "government take". Reference is made to Chapter 4.5 in "Preparation for Oil Exploration" for details on the main elements of petroleum taxation.

The reasoning underlying the levies on the licensee is twofold: first, that the Faroe Islands have a proprietary right to the resources of the subsoil, and thus a right to secure a share of any profits made from the exploitation of those resources; second, petroleum companies, like all other businesses operating in the Faroe Islands, the continental shelf included, should be taxed on the basis of their income. The aim is to subject income from exploration and production activities to tax in the same way as other income, and also to impose levies or taxes which secure a share of the so-called "resource rent" from the hydrocarbon activities for the Faroese society. Resource rent is income which the exploitation of a natural resource produces in excess of a usual remuneration of the factors of production, such as wages and salaries and an acceptable rate of return on the capital invested.

4.3.1. Application fee and rentals

From the outset, it has been government policy that the management of petroleum affairs should not involve any significant cost for the Faroese taxpayer. The preliminary surveys carried out since the Faroe Islands took over responsibility for mineral resources in 1992 have all been conducted and paid for by the oil industry, and the cost of issuing and administering the permits has been financed in part by fees.

When filing an application for an exploration and production license applicants must pay an application fee which helps finance the costs incurred by the Faroese authorities in preparing the licensing round and processing the applications. The application fee has been fixed at DKK 100,000 for each application, whether from an individual company or from a consortium of companies.

Once an exploration and production license for specific blocks has been obtained, the successful applicant must pay an annual rental, cf. clause 7 of the Model License. The area rental per square kilometre of seabed increases progressively from DKK 500 per square kilometre for the first six years to DKK 39,000 per square kilometre for the 16th and possible subsequent years. The revenue from this progressive increase in rental may be diminished if companies relinquish parts of their license area. One of the objectives of the progressive rental is to induce companies to relinquish areas which they are not willing or able to explore thoroughly.

When production is initiated, the rental is abolished for the area of production and replaced by other levies based on the value of, and income from, production.

4.3.2. Royalty

A traditional means whereby the owner of a proprietary right (licensor) can secure a share of the income obtained by a user of this right (licensee) is to lay claim to a share of the production, or of the production or sales value, in the form of a royalty, which is frequently calculated as a production levy.

The license imposes a production levy, or royalty, calculated as 2% of the value of the hydrocarbon production, cf. clauses 8 - 10 of the Model License. The royalty shall be calculated on the basis of the landed value of the production. This method is regarded as a simple way to calculate such a levy that is not difficult to administer.

For the Treasury, one advantage of levying royalty, as opposed to tax, is that revenue is obtained as soon as production starts. However, as a levy on gross production value seldom reflects profitability, the use of such an instrument is strictly limited in order to avoid unintentional consequences. Therefore, it is not considered prudent to set the rate higher than 2%.

4.3.3. Corporation tax

Act No. 26 of 21 April 1999 on taxation of income from hydrocarbon activities establishes a legal framework for standard taxation of income from activities on the Faroese continental shelf. This means that companies which earn income from petroleum production or associated supply activities are subject to Faroese taxation, and thus liable to pay corporation tax, currently levied at the rate of 27%.

The Faroese corporate tax rate, which has remained at 27% to date, is low compared to the rate payable in neighbouring countries and the countries of many oil companies. Thus, the corporate tax rate is 30% in the UK and 35% in the USA. Generally, the companies obtain a credit in their home country for corporation tax paid in other countries if they can prove that the tax is an income tax in the usual sense of the word. However, the credit may not exceed the domestic tax that would be payable on the same income. If the tax payable in the Faroe Islands is lower than the tax payable in the companies' countries of residence, the companies may have to pay domestic tax on their Faroese income, over and above the tax paid in the Faroe Islands, a revenue that could have accrued to the Faroese treasury if the Faroese corporate tax rate had been higher than the current 27% but not higher than the rate payable in the companies' home countries. In that case the low Faroese tax would benefit the home countries, not the companies themselves.

However, the situation is more complex. Some countries, such as the Netherlands, do not give credit for foreign tax, but grant an exemption for foreign-source income. For companies from such countries, a higher Faroese corporate tax rate would be a real burden. For US-based companies, there are certain possibilities for pooling income from several foreign jurisdictions, thus evening out income from high-tax and low-tax countries, before the companies apply to the US authorities for a tax credit. Therefore, the low Faroese corporation tax may benefit the majority of oil companies, and a Faroese corporate tax rate above

27% might become a real burden for other companies. Rules about tax credits, etc. may also be laid down in double taxation treaties, i. e. treaties protecting the countries' residents against double taxation of foreign-source income.

One argument against subjecting petroleum production income to a higher corporate tax rate than the current rate is that oil companies which have shown an interest in exploration off the Faroe Islands know that the Faroese corporate tax rate is 27%. Thus, they could perceive an increase as indicating a lack of stability in the Faroese petroleum tax regime.

Now that it is being debated whether to reduce the Faroese corporate tax rate (27%) even further, for example to 20%, extending such a tax reduction to petroleum production income might be contemplated. However, this would have to be counterbalanced by an increase in other elements of the petroleum tax regime, i. e. royalty (which, as mentioned above, is not an equitable type of tax), or the special hydrocarbon tax, which also has its disadvantages, e.g., it generates a highly unstable revenue. Furthermore, corporation tax is the tax element for which foreign oil companies can be certain to obtain a tax credit in their home countries. It is considered advisable to take this opportunity to emphasise that a stable Faroese petroleum tax regime is planned, and consequently the corporation tax payable on petroleum production income will be maintained at the present level of 27%, which is the rate that will be stipulated in the relevant legislation.

4.3.4. Special hydrocarbon tax

In view of the relatively low Faroese corporate tax rate (27%), oil companies deriving an income from the extraction of resources from the Faroese subsoil are considered to have a duty - and the ability - to pay higher taxes if their return on the capital invested exceeds a rate reflecting the risk of exploration on the Faroese continental shelf and the risk associated with establishing production facilities under the conditions prevailing in the Faroese area.

Therefore, in addition to corporation tax, income from hydrocarbon production in the Faroese jurisdiction will be subject to a special tax, viz. a special petroleum income tax. This option was mentioned in the explanatory notes on the Bill on Hydrocarbon Taxation (Parliamentary matter no. 79/1998). The details of the special tax will be laid down in a bill which the Minister of Finance will present to Parliament in the near future.

The intention is for the special tax to be levied in addition to corporation tax, and thus to tax the profits of a company that exceed a certain internal rate of return ("IRR" or "ROR").

When oil companies consider where to invest, they attach weight to the possibility of obtaining an internal rate of return (usually after corporation tax) that exceeds the market rate of return to such an extent that it compensates for the risk taken. The risk consists of the exploration risk, i. e. the risk that exploration does not lead to commercial discoveries, and the risk that an oil field does not become sufficiently profitable, either because of higher development costs, lower production rates or lower oil prices than expected.

The special tax will be targeted at income from petroleum projects which are especially profitable and can be said to render a very high resource rent. Therefore, the special income tax will be levied on a “ring fence” basis, i.e. field by field.

4.3.5. Summary and recommendation regarding fiscal terms

The total taxes, levies and fees should be viewed as a whole, and a balance must be struck between the country’s right to gain a maximum income from its natural resources and the risk assumed by oil companies when initiating hydrocarbon exploration.

In some neighbouring oil countries, viz. the UK and Ireland, the current taxation of income from new petroleum discoveries is very light, consisting of corporation tax only, which is levied at the rate of 30% in the UK and 25% in Ireland. However, according to international experts in petroleum economics, oil companies do not expect taxation in such countries as the UK to remain at the current low level if preconditions change, e.g. if large discoveries are made or if oil prices remain high.

In connection with the opening of the Faroese area for exploration, there is a limit to how burdensome terms the Faroese authorities can impose on licensees.

It is of paramount importance that the tax regime imposed now on petroleum income is structured in such a way that it will be perceived as stable. The tax regime must be able to withstand changes in oil prices as well as in development or operating costs. Government revenue, and thus the taxes payable by oil companies, must be flexible enough to allow for changing circumstances, such that alterations to the tax regime will not be required.

The current market situation is considered to justify a regime with the three types of levies and taxes described above: (i) a low royalty - 2% of gross value, (ii) corporation tax at the prevailing rate - 27%, and (iii) a special tax on particularly high incomes. A “government take” of just over 50% of the profits from a reasonably profitable oil field is considered appropriate. The marginal tax rate of all three taxes combined should probably not considerably exceed approx. 55% on a net basis, i. e. taking into account that royalty is an allowable expense when computing the two other types of tax and that one of the two income taxes, generally corporation tax, is deductible when computing the other income tax, viz. the special tax.

If a national oil company is established, or an option is introduced for the government to demand a carried interest for a national oil company, the tax regime envisaged will have to be thoroughly revised. A requirement for the licensees to “carry” a national company in the exploration phase, and particularly in the development phase, will be regarded as an additional fiscal burden that will be considered extra heavy when the exploration risk is perceived as being high. If a carried interest is introduced in this round, it would be appropriate to restore balance in the fiscal regime by reducing the other fiscal elements, bearing in mind that many private oil companies are reluctant to enter into obligatory co-operation with a state-owned company.

On the whole, it is considered doubtful whether it is realistic to demand a carried interest for a national company as well as to levy a special tax. Considering that a special tax, if exploration is successful, could become an important source of government revenue, the price of a carried interest might prove excessive.

4.4. Terms relating to Faroese participation

Under section 10 of the Hydrocarbon Activities Act, licenses for exploration and production of hydrocarbons must incorporate provisions regarding the involvement of Faroese undertakings and the use of Faroese manpower. In addition, section 11 of the Hydrocarbon Activities Act stipulates that all equipment and passengers to and from the Faroese shelf area must be transported via a Faroese quayside or airport. The terms and conditions regarding Faroese involvement are set out in clauses 11 through 15 of the Model License and have been prepared in co-operation with industrial organisations and the Ministry of Trade. As stated in the notes on section 10 of the Hydrocarbon Activities Act, the aim of these provisions is for the licensees' activities to result in economic activity in the Faroe Islands in real terms. Such business development possibilities are also the aim of the Faroese government's industrial policy, which was debated in the Faroese Parliament in spring 1999, and formulated as follows: *"A viable economy based on various trades and industries, providing profits, progress and prosperity in free international competition, and according high priority to workplace conditions and the environment."*

The scope of the business development possibilities arising in the wake of hydrocarbon activities will be limited in the exploratory phase, while the level of activity will increase considerably if exploration leads to development and production. However, it is not possible at present to assess the rate at which business opportunities will emerge, as it is not known whether, when, and on which scale, a development and production phase will be initiated. Therefore, during the exploratory phase, the aim is to improve the competitiveness of Faroese undertakings, in order that the Faroese business community can gain access to new markets and product areas, regardless of the rate at which activities progress on the Faroese continental shelf.

Below, an outline is given of the terms and conditions relating to Faroese participation in the hydrocarbon activities. The outline is divided into five themes: the licensees' activities on shore, Faroese supplies, building up competence and technological know-how, training/education and research, and employment opportunities.

4.4.1. The licensees' activities on shore

It is stipulated in clause 15 of the Model License that the licensees' activities must be based in the Faroe Islands, in accordance with a plan to be submitted by the licensee for approval by the Minister of Petroleum. It will be a condition that the operator sets up offices in the Faroe Islands and that the representative of the operator in the Faroe Islands has adequate authority to represent the licensee in dealings with the authorities.

The Minister of Petroleum will not stipulate where in the Faroe Islands a supply base should be located. However, it is necessary to prevent any needless investments in harbour facilities.

In addition to the requirement that the activities of the licensee be based in the Faroe Islands, clause 14 of the Model License requires all supplies for the activities to be transported via a Faroese quayside or airport, in accordance with the requirement to this effect laid down in section 11 of the Hydrocarbon Activities Act.

These provisions give Faroese undertakings good prospects of working with the oil industry, and will therefore have a direct impact on the level of activity in the Faroese business community. As well as creating jobs, this will stimulate competitiveness.

Section 11 was inserted in the Hydrocarbon Activities Act in order to ensure that supply bases are located in the Faroe Islands. Moreover, the Faroese Parliament considers that this provision will give Faroese undertakings the opportunity to take part in the activities from the outset, thus promoting an easier, more rapid increase in competitiveness, internationally as well as domestically. Thus, the aim of this provision closely resembles the objective of section 10 of the Hydrocarbon Activities Act, and should be considered a supplement to section 10.

According to section 11(2) of the Hydrocarbon Activities Act, the Minister of Petroleum may in special cases grant an exemption from the requirement in subsection (1). The authority to grant exemptions is limited, and will be applied only in those cases where the granting of an exemption cannot be considered contrary to the purpose of the provision.

Firstly, exemptions are conceivable in cases that fall outside the purpose of the provision. Such cases include emergencies where quick action will be required for the immediate transporting of injured persons as well as equipment to control pollution and fire, and where the refusal to grant an exemption would endanger human lives and cause potential damage to the environment and real or personal property.

Secondly, this provision is aimed at situations where the refusal to grant an exemption would result in disproportionately high extra costs for the licensee, e.g. in case of suspension of production where the spare parts required are unavailable in the Faroe Islands, and where quick action is essential.

Further, it may become necessary to grant exemptions for goods that it would be meaningless to ship via a Faroese quay. Such exemptions are conceivable for the delivery of large platform modules, heavy machinery and other major components that are ordinarily delivered direct to the field. The same applies to non-recurrent services provided by special transportation, including special-purpose vessels. Exemptions may also be granted for goods for which the Faroe Islands do not have the necessary handling facilities.

It should be emphasised that in compliance with the requirement in section 11(1) of the Hydrocarbon Activities Act, exemptions will be granted in exceptional cases only, and the Minister of Petroleum intends to pursue a business policy that gives Faroese trade and industry an opportunity to take part in the hydrocarbon activities in the Faroese shelf area, in accordance with the aim of the Faroese Parliament.

4.4.2. Faroese supplies

To further promote the involvement of Faroese undertakings in hydrocarbon activities, clause 11 of the Model License stipulates that Faroese undertakings must be given genuine opportunities, in competition with other companies, to obtain general contracts and subcontracts and to provide goods and services. This commitment applies to both the licensee and the licensee's contractors/subcontractors.

In addition to the prospect of purely financial gains, Faroese access to the market opens up opportunities for Faroese companies to gain experience and good business references by supplying and co-operating and doing business with international companies. These contacts can form the basis for further business development, with the penetration of export markets as the ultimate goal. Thus, by providing trade and industry with a platform for doing business with the international oil industry, the Faroese government supports a business development that provides an opportunity for diversifying into areas other than the Faroe Islands' main business areas and internationalising Faroese trade and industry.

The Faroese business community has a long tradition of supplying goods and services to the maritime sector, and the expertise in this area will form a natural basis for entering into contracts related to activities on the Faroese continental shelf. However, there will be cases where Faroese undertakings are not directly capable of competing, either because of the size of the contract or because the company in question does not meet the formal requirement for offshore business references.

On the basis of these considerations, the Minister of Petroleum will draw up procedures for the licensees' publication of information about planned activities, as well as for inviting tenders and reporting on contractual relationships. According to these procedures, licensees will be required to submit information about planned activities in good time, so that potential suppliers will have sufficient time to prepare bids, plan their use of resources, adapt manufacturing processes if necessary, and find appropriate business partners. Moreover, the procedure for inviting tenders will specify that contracts must be subdivided appropriately so that Faroese suppliers can submit tenders for subcontracts whenever possible. In addition, it is a requirement that the qualifications of Faroese undertakings are evaluated as a whole, and that a lack of offshore business references will not on its own constitute sufficient grounds for excluding individual Faroese suppliers from participating in the activities.

The requirement for involving Faroese undertakings in hydrocarbon activities will be linked to the requirement that the licensee and its contractors investigate the possibilities of procuring supplies from Faroese trade and industry. Thus, if Faroese undertakings are to gain access to this market, foreign companies must fairly easily be able to form a general view of the supplies and services, subservices and suppliers available in the Faroese Islands. Faroese industry is working to solve this problem, and intends to set up a database that gives an overview of Faroese goods and services, as well as the qualifications of the individual suppliers. Such a database will make it easier for both the oil companies and their contractors/subcontractors to comply with the requirement that Faroese undertakings must be given genuine opportunities to obtain contracts.

Such lists of suppliers are used in connection with invitations to tender in accordance with the EU Directive on public procurement. The use of databases may therefore promote the internationalisation of Faroese industry and become a stepping stone for Faroese suppliers to become listed elsewhere. This gives potential for penetrating new markets.

The reports to be filed by licensees in connection with entering into contractual relationships must indicate how many Faroese suppliers were given an opportunity to bid for contracts, how many Faroese undertakings were awarded contracts, the import content of the individual supplies and the value added to them in the Faroe Islands.

In enforcing the provisions aimed at ensuring the involvement of Faroese trade and industry in hydrocarbon activities, the Minister of Petroleum will, on the one hand, promote the development of Faroese industry and, on the other, show the necessary amount of understanding for the potential difficulties that may arise for the licensees as a consequence of these terms.

4.4.3. Building up competence and technological know-how

Apart from gaining access to the market for day-to-day supplies, it is considered desirable for the hydrocarbon activities to involve a targeted transfer of know-how from foreign companies to the Faroese business community. This wish falls in line with the Faroese government's declared industrial policy and is dealt with in clause 12 of the Model License.

The aim of clause 12 of the Model License is to give undertakings desiring targeted strategic development an opportunity to upgrade their qualifications and technological know-how by entering into co-operation with foreign companies. It is the licensee's responsibility to enable and promote the conclusion of such contracts. This co-operation may take different forms, e.g. joint ventures, supply chain agreements, or temporary business relationships. However, it is a requirement that the extent of the individual Faroese undertaking's involvement in specific contracts for supplies enables it to obtain business references, which are an essential prerequisite for its access to new markets.

The co-operation envisaged by clause 12 may take place between a Faroese undertaking and the licensee or, in the alternative, with the licensee's affiliate, contractor/subcontractor or business partner. The work comprised by the co-operation need not relate to oil and gas activities on the Faroese continental shelf, but may include petroleum-related activities abroad.

The objective of this scheme is for the relevant Faroese undertakings to upgrade their qualifications or obtain new skills, both with respect to know-how, technology and management. During this process, the Faroese undertaking should be able to improve and/or expand its business base, and to increase its international competitiveness.

For the scheme to work, it is vital to provide the licensees with a basis for evaluating which Faroese undertakings have sufficient development potential to ensure successful transfer of know-how. The Faroese undertakings that wish to benefit from this scheme should therefore prepare a written presentation outlining the individual undertaking's strategic deliberations.

The Minister of Petroleum will require the licensees to report regularly on the transfer of know-how. In this connection, the licensee must provide information about the contractual relationships planned or already

established by the licensee, as well as the results realized. For this purpose, the above-mentioned profiling of the undertaking can be used to assess the results.

4.4.4. Training, education and research

Upgrading qualifications by training, education or research activities is a key parameter in international competition and consequently of great importance to business policy aims. In this area, the oil companies have already displayed their willingness to co-operate during the prospecting phase. Initiatives in this area could include training programmes for individuals and research projects, such as the GEM co-operation. Therefore, it is natural for the public administrative and private business sectors to build on this opportunity to upgrade qualifications. Clause 13(1) and (2) of the Model License contain the relevant provisions on such training and research.

The undertakings entering into contracts as provided for by clause 12, and thus undergoing strategic development, will have a particular need for theoretical and practical supplementary training for their employees. Other suppliers facing new requirements and opportunities by virtue of the activities on the Faroese continental shelf will also need training for their employees, initially within the area of safety, but increasingly within other areas as well.

Research, both in the public and the private sectors, is today considered one of the prerequisites of growth in trade and industry. Therefore, over time, it may be of great importance to the Faroese industrial development that national research institutes and business undertakings are invited to participate in relevant projects carried out by the licensee.

4.4.5. Employment opportunities

Job creation is expected as a result of the location of the licensees' activities and supply bases in the Faroe Islands. Moreover, the stipulations regarding Faroese involvement contained in the licenses will lead to an increased level of activity for suppliers, with ensuing employment opportunities.

In accordance with the requirement laid down in section 10 of the Hydrocarbon Activities Act, a provision has also been incorporated into clause 13(1) of the Model License that requires the licensee to provide employment opportunities for Faroese citizens in connection with activities on the Faroese continental shelf.

4.5. A national oil company

By giving scope for petroleum activities, the Faroese government hopes to create public revenue, a more varied industrial base and a higher level of activity in the Faroe Islands. The instruments to achieve these objectives include fiscal and industrial measures, as described in chapters 4.3 and 4.4. above. Both the Act on Hydrocarbon Activities and the Model License contain provisions on the right of public authorities to demand insight into the activities undertaken by licensees. A national oil company could also serve these purposes.

The relevance of establishing a national oil company is dealt with in detail in the report "Preparation for Oil Exploration", pp. 219 - 245, and in the report "Organisation of a Faroese National Oil Company", prepared by a working party and submitted to the Minister of Petroleum in October 1999. "Organisation of a Faroese National Oil Company" discusses mainly issues of ownership, management, commercial and community objectives, etc. The report contains a detailed proposal for the organisation of a national company, including a draft bill on its formation, draft articles of association, etc.

As mentioned in chapter 3.3. above, the establishment of a Faroese National company whose costs would have to be carried by its partners¹ through the exploration phase is a doubtful proposition with the present state of global competition. The competitive strength of the Faroe Islands as an exploration area in 1999 is much less than that of the North Sea countries in the 1960s and 1970s when large regions of the world, e.g. the Soviet Union, part of the Arab countries, Latin America, part of Asia, etc., were closed to international oil companies. Because of the limited options open to international oil companies, host countries were able to demand a high degree of carried participation. Reference is also made to chapter 4.3.5 above, where the issue of a national oil company is dealt with along with other fiscal requirements. This is just one of several reasons to consider the matter in depth before deciding to establish a national oil company.

4.5.1. External advice

An international consultancy company, which assisted the Ministry of Petroleum in preparing the licensing round, has also considered the option of establishing a national oil company. The firm is aware that the governments of some neighbouring countries consider a national oil company a necessary means to achieving more control of the oil industry, more insight into the activities of the licensees, a higher share of the profit from the activities, etc. For the time being, however, the trend is towards full or partial privatisation of national companies. Thus, Norway is considering the future of Statoil.

The consultants maintain that some of the reasons for establishing a national oil company will not hold in the longer term. For example, government control of upstream activities and access to relevant information could be guaranteed through legislation by imposing certain limits on the activities of the oil companies and obtaining an appropriate share of the income through taxation. It is doubtful whether a Faroese national oil company would be commercially viable considering the substantial risk currently characterising exploration on the Faroese continental shelf.

According to the consultants, the oil industry may have the following reasons, among others, for not wanting a national oil company:

- government involvement in a license introduces an additional complexity with respect to evaluating opportunities and making investment decisions. The need to carry a government oil company's cost in an exploration well may, in some cases, alter the expected monetary value from the well to the extent that it is not drilled;

¹ When a company is "carried", the other licensees pay its share of the exploration costs and - more rarely - the field development costs. These costs may be repaid, in whole or in part, out of the carried company's share of the production profit. Usually, the company's own operating costs are not carried by the other participants.

- government involvement in the Faroes will reduce the level of equity available to companies in licenses and lower the level of materiality that the province can offer to major oil companies;
- the terms and conditions of the licensing and fiscal legislation are demanding in comparison to neighbouring frontier regimes such as the UK. The addition of a state oil company into the legislation may deter some companies from participating in the Faroes' first licensing round.

All in all, the consultants consider that Faroese authorities will be able to achieve all the objectives usually associated with a national oil company by using the instruments already available through the Act on Hydrocarbon Activities and the Act on Hydrocarbon Taxation; see chapter 4.5.2 below. According to another well-esteemed international expert consulted by the Ministry of Petroleum, it will not be possible to include both a carried interest and a special hydrocarbon tax in the package.

4.5.2. Tasks of a national oil company

The objectives of a national oil company may include:

- building up competence
- improving access of Faroese suppliers
- providing an additional or alternative fiscal instrument
- exerting direct influence on consortium decisions
- improving insight into consortium operations
- promoting long-term socio-economic goals
- ensuring security of supply.

Since it is deemed inadvisable to include a carried national interest in the first licensing round, it is explained below how the above-mentioned objectives may be achieved by other means than a national oil company.

The objectives of building up competence and promoting the supply of goods and services from Faroese companies are met by requiring licensees to provide Faroese companies with genuine opportunities to supply goods and services and develop know-how, technology and management; see clauses 11 - 15 of the Model License and chapter 4.4. above. These provisions were laid down in consultation with the Faroese industry to ensure their acceptability to the intended beneficiaries of this industrial policy.

A national oil company is not necessary as an additional or alternative fiscal instrument, as the fiscal package is designed to secure the highest possible share in the financial result for the Faroese community. As mentioned in chapter 4.3. above, including a carried interest or an option hereof in the licensing terms may necessitate modification of the fiscal terms and, possibly, exclusion of the special hydrocarbon tax.

The authorities can influence decision-making through the regulatory framework established by legislation, including the provisions for licensees to obtain special authorisation from the petroleum authorities before initiating certain activities, such as a drilling permit under section 15(1) of the Hydrocarbon Activities Act. The authorities are also entitled to attend the meetings of the operating committees of the various consortia.

It is doubtful how much further a Faroese national oil company would be able to influence its co-licensees. At any rate, a national company would probably hold only a minor share in any specific license. Furthermore, a carried partner is not considered a paying member of the consortium. These factors alone limit the influence of any such company. It would take a national oil company several years to build up the necessary competence to be able to influence the consortium to any material degree.

The authorities are empowered by legislation to demand insight into the activities. Thus, the Minister of Petroleum may issue executive orders under which the licensee must disclose information on most aspects of its activities, including financial and geological matters. The Model License includes numerous provisions for the licensee to submit information about matters such as the extent to which Faroese industry will be involved in the activities under the license. Insight may also be gained by attending operating committee meetings.

A national oil company might prove a useful tool for achieving long-term socio-economic objectives in the event that international companies fail to show commercial interest in petroleum activities in the Faroese area. Should this situation arise, a national oil company could be instrumental in marketing the country as an exploration area in the same way as Greenland, for example, has used Nunaoil. To date, it has been Faroese policy to base petroleum activities on the Faroese continental shelf on the commercial interest of the international oil industry, and no government funds have been allocated for initial prospecting. The Faroe Islands are situated close to well-known oil fields, and this is considered sufficient incentive for the international oil industry to initiate substantial oil exploration on the Faroese continental shelf - provided that the terms and conditions are competitive.

Domestic security of supply may be ensured by a number of other measures. Thus, under the auspices of the Danish government, the Faroe Islands are comprised by the emergency supply mechanism of the IEA (International Energy Agency). Another measure is the option for the Faroese government to demand payment of royalty in kind, stipulated in clause 8(4) of the Model License.

In conclusion, most of the socio-economic objectives mentioned above can be achieved with instruments already available to the authorities under the Act on Hydrocarbon Activities, the legislation on hydrocarbon taxation, or the stipulations to be made in the exploration and production licenses.

4.5.3. Cost

Cost is another important consideration.

Establishing a national oil company will initially impose certain costs on the Faroese community because some of the terms and conditions of the present proposal will have to be made less stringent. The exploration costs of a national oil company participating in this round will probably have to be carried by the other participants. Whether carried costs will be repaid in the event of commercial discoveries does not have any major influence upon a company's decision to apply for a license. The cost of carrying a partner is generally regarded as an outlay for which companies will expect to receive some form of compensation.

The costs involved can be illustrated by an example, based on an estimated exploration cost for each license of DKK 300 million. Assuming a 5% share for the national oil company, the carried cost will be DKK 15 million per license. If ten licenses are granted, the total cost is DKK 150 million.

If a commercial petroleum discovery is made, the company will also have to obtain finance for development. Field development involves heavy costs, easily amounting to DKK 10 billion. Thus, with a 5% share, the company would have to raise DKK 500 million per field. There are examples of national oil companies having failed to raise sufficient funds, thus causing delays in field development.

Add to this the operation costs, which depend on the company's staff requirements and time of formation. If the company is established at the beginning of the exploration phase, it will have to pay operating expenses throughout the exploration phase. These expenses can be avoided if establishment is delayed until commercial discoveries are made.

A company that wants to exert influence must possess the necessary competence and expertise. It is difficult to estimate the staff requirements, but the payroll costs will probably run into a few million Danish kroner, to which should be added the cost of office space, equipment, and - not least - obtaining and interpreting seismic data.

4.6. Private Faroese oil companies

The report "Preparation for Oil Exploration" does not consider it likely that sufficient private Faroese capital can be raised to establish an oil company with the necessary capacity to assist the interests of the community associated with an oil industry in the Faroe Islands.

However, two private Faroese oil companies have already been established.

It is essential that the private Faroese oil companies be treated on an equal footing with other oil companies, which means that groups which include Faroese companies must be able to submit applications that can compete with those submitted by other companies/groups.

It would be most unfortunate for the Faroese community if international oil companies – especially groups without Faroese partners – were to get the impression that groups including private Faroese oil companies were given preferential treatment only because they had Faroese companies as members. At worst, it might deter some companies from participating in the licensing round.

4.7 Other general licensing terms

Clause 17 of the Model License stipulates that representatives of the Ministry of Petroleum shall be entitled to participate as observers in joint committee meetings. Clauses 18 and 19 address the obligation of licensees to grant the staff of the supervisory authority all the assistance required for their investigations and provide the authorities with all the information specified in executive orders.

Clauses 20 and 21 address confidentiality obligations, confidentiality period, etc.

Clause 24 stipulates that co-licensees shall be jointly and severally liable for any compensation and damages payable to fishermen pursuant to section 7 of the Act on Hydrocarbon Activities. Licensees must guarantee that they can meet this liability.

According to Clause 26, the license cannot be transferred without the approval of the Minister of Petroleum.

5. Safety, (working) environment and emergency procedures

Under the provisions of section 14 of the Hydrocarbon Activities Act, all “exploration and production shall be carried on in a safe and appropriate manner”. This requirement applies to both licensees and public authorities. It is the licensee’s responsibility to ensure that activities are planned and executed with due regard to safety. The authorities are responsible for monitoring compliance with this requirement.

Part 5 of the Hydrocarbon Activities Act empowers the Faroese Government to lay down more detailed rules and regulations on safety, (working) environment and emergency procedures, etc. Such rules will be drawn up before hydrocarbon activities are initiated. Applicants will be required to submit information regarding certain safety issues to the authorities.

Applications for exploration and production licenses must outline the applicant’s own standards for safety, (working) environment and emergency procedures, which must reflect conditions in the shelf area comprised by the application.

In addition, applications must contain a general description of the applicant’s competence regarding drilling operations in both shallow and deep waters in the offshore area comprised by the application. The description should describe the applicant’s safety, (working) environment and emergency procedures, with emphasis on the following: (i) guidelines for drilling operations, (ii) special circumstances to be taken into account when drilling in deep waters, (iii) the measures taken by the applicant to deal with the risks involved in drilling operations, and (iv) the applicant’s own standards for training and involving its personnel in the planning and implementation of drilling operations.

The operator is presumed to have a SAR helicopter service on standby in the Faroe Islands during the drilling of exploration wells, and to keep heavy seagoing emergency equipment at a suitable base in the Faroe Islands that can be called in the event of oil spills.

6. Impact on fishing, the environment, etc.

Under section 7(2), second sentence, of the Hydrocarbon Activities Act, the explanatory notes to the Act on the First Licensing Round must include an assessment of the possible impact of hydrocarbon activities on navigation, fishing and other commercial activities, and on nature, the environment and other community interests. The explanatory notes shall also include an assessment of the effect of the activities on the Faroese economy and employment opportunities.

Chapters 6.1 to 6.7 below assess the possible impact of the contemplated hydrocarbon activities on these factors.

The assessments referred to in chapters 6.1 to 6.5 were made by a working group appointed by the Minister of Petroleum and including representatives from the Ministry of Fisheries, the Fisheries Laboratory, the Food and Environmental Agency and the Ministry of Petroleum. The Ministry of Petroleum invited fishing organisations and other industrial organisations to an information meeting on 29 September 1999 where the assessments were presented. No objections were raised to the assessments.

Although the Hydrocarbon Activities Act specifies that the explanatory notes shall assess the "impact" of hydrocarbon activities, the working group generally focused on negative rather than positive potential effects.

The assessments apply to the area to be offered for licensing; see Schedule A. They are based on an average level of activity in the exploration phase regarding the scope of work programmes, duration of the exploration phase, etc. The assessments are further based on information on industrial and environmental conditions obtained from public authorities and institutions, e.g. data from logbooks on fish catches in various areas.

6.1. Impact on navigation

Exploration activities on the Faroese continental shelf may have a two-fold effect on the navigation of fishing vessels and other vessels:

1. Offshore installations occupy a certain acreage and may therefore hinder navigation in Faroese waters. Under section 28(1) of the Hydrocarbon Activities Act, safety zones are to be established around offshore installations, the extent of which is determined according to international rules, the standard radius being 500 m.
2. Exploration activities on the Faroese continental shelf will increase traffic in Faroese waters and may consequently affect navigation and the fishing industry.

The extent of such effects on navigation and traffic depends on the scope of the exploration activities, the number of offshore installations, etc.

It is assumed that the number of offshore installations operating in Faroese waters during the exploration phase will be limited, as will the need for sea transportation to and from these installations. Therefore, the exploration activities and resulting ship traffic are unlikely to hinder navigation to any material degree.

6.2. Impact on fishing

In an assessment of the impact of exploration activities on fishing, the key issues are the location of exploration sites, the nature of any fishing activity in these areas, the number of operating offshore installations and the size of the areas they will occupy.

Normally, an offshore installation is surrounded by a 500 m safety zone (cf. chapter 6.1 above) within which all fishing is prohibited. In the case of anchored installations, the anchor zone may have a larger radius than the safety zone, depending on the water depth in the area. Generally, the distance from the installation to the anchors is 4-5 times the depth. When considering the impact on fishing, it is necessary to distinguish between various types of fishing activity and fishing gear. The impact depends on whether bottom trawls, floating trawls, purse seine, longline or gillnets are used, and whether demersal or pelagic fish are targeted.

Fishing for demersal species normally takes place in water depths less than 500 m. The impact on this type of fishing activity is therefore limited if the hydrocarbon activities are carried out in deeper waters. Most of the area offered for licensing is located in waters deeper than 500 m.

The greatest impact from exploration activities carried out from an offshore installation will be experienced by trawlers using bottom trawls, because the 500 m safety zone reduces their fishing area. The impact varies, depending on whether the trawling area is on a slope or a more even seabed with only minor topographical variations, as it is easier to trawl around offshore installations situated on an even seabed than on a slope with sudden changes of depth.

The effect on longline and gillnet fishing is generally less than on bottom trawling. However, it depends on the type of fishing activity in the exploration area and the extent to which other fishing grounds can compensate for any reduced or lost fishing grounds.

The Faroese fishing fleet consists mainly of small vessels operating close to the shore with jigging machines or longline. The expected exploration activities will not have any major impact on this type of fishing activity.

Pelagic fishing mainly takes place by purse seine (herring and mackerel) or pelagic trawls (blue whiting). The location and time of year depend on where the fish are to be found at any given time and may vary from one year to the next. International research shows that hydrocarbon activities are unlikely to affect migration patterns. Furthermore, offshore installations rarely affect the location of pelagic fishing. Offshore installations are therefore fairly unlikely to cause problems for pelagic fishing activities.

International research has demonstrated that seismic activity may cause evasive behaviour in fish. This is also expected to apply in Faroese waters. The seismic warning system established by the Fisheries Inspection in 1998 has been successful. Currently, seismic activity is only allowed from 15 April to 1 November. It may be necessary to further limit the period for seismic activity in certain areas, for example south of the Munkagrinnur ridge, when the blue whiting reaches Faroese waters, i.e. around May.

In conclusion, the exploration phase will not pose any serious obstacles to fishing, although exploration activities to the east and south of the Faroe Islands may affect fishing opportunities in certain fishing grounds. This is mainly because the depth in most of the area offered for licensing exceeds 500 m, whereas fishing vessels generally operate in shallower waters. Only a few offshore installations will be needed in Faroese waters, and the areas occupied will be correspondingly small. It is also important to remember that

in the initial phase their presence will be needed for a limited period only, as drilling an exploration well normally takes 50-80 days. Thus, the activities will not substantially reduce fishing opportunities.

The activities will be planned with a view to minimising any inconvenience to the fishing industry. It is therefore essential that the rules and regulations to be implemented for the fishing and oil activities be worded with due consideration for the interests of both parties. So, communication between the parties is vital. Fishing interests must be considered when specific exploration plans are prepared. The Minister of Petroleum intends to appoint a co-operation committee of representatives from the fishing and oil industries. However, before this happens, he has agreed to hold an information meeting with the fishing organisations next year after the exploration licenses have been granted. By then, details of the allocation of blocks, oil company work programmes (drilling and seismic activities), the expected commencement and location of drilling activities, etc. can be publicised.

6.3. Impact on other industries – competition for manpower

The exploration activities may increase competition for manpower, and there is a risk that people may decide to change industry. This may have both direct and indirect effects on the fishing and other industries.

The introduction of a new industry will have a direct impact on the Faroese labour market. The demand for personnel both offshore (installations, supply and standby vessels, etc.) and onshore (supply bases) may lead to competition for manpower.

Initially, however, activities will generally be on a small scale, and the new offshore installations and supply bases are unlikely to cause any substantial increase in the demand for Faroese manpower. Normally, the requisite installations are chartered fully equipped and staffed, and the man-year requirement of the supply bases will be minimal in this phase, even if they have to service several offshore installations at the same time.

The indirect impact will be felt as increased activity in other industries due to rising overall demand for goods and services. This is likely to have a greater effect on competition for manpower, as the oil industry and other industries may compete for labour to cover their staff requirements.

The extent of the indirect impact will depend on the scale of the exploration activities, the number of new jobs created and the role of the Faroese business community. However, it is vitally important that the fishing industry remains competitive. If personnel from the fishing industry prefer to work in the oil industry or associated onshore activities, the reasons must be analysed. Experience from other countries shows that income is not the only motivation: leisure time, pension schemes, future prospects, etc., are also important.

However, in light of the anticipated level of exploration activity and manpower demand, these factors are not likely to have any substantial effect on other industries in the exploration phase.

6.4. Impact on nature

One direct impact of exploration activity would be the disturbance to the fauna of the exploration area, especially bottom dwellers, marine organisms, fish, birds and marine mammals. But since these species migrate through or over the ocean, they can leave the area and return unhindered when the exploration activity is over. The impact on such species is therefore likely to be limited.

6.5. Impact on the environment

The hydrocarbon industry as a whole is regarded as a source of pollution, mainly due to the discharge of waste and other residues into the sea or air. The type and extent of environmental impact will depend on safety regulations, measures to protect the environment, etc. In recent years, the oil industry has improved the organisation of its activities to include the necessary measures to safeguard the environment and nature.

Discharges resulting from the drilling of exploration wells include drill bits and drill mud, concrete residue, sewage and household waste, cooling water, fumes and vapours, as well as accidental leakage. Unless the necessary measures are taken, these substances may cause environmental pollution with potential biological consequences. This may negatively affect both animal populations and other industries in the area.

Environmental effects may include the accumulation of toxic substances in bottom dwellers, ocean sediments and smog. According to the main provision of section 14 of the Hydrocarbon Activities Act, the activities are to be carried on with due consideration for the environment. Therefore, environmental measures are essential in all phases of hydrocarbon activities.

According to section 6(1), second sentence, of the Hydrocarbon Activities Act, "licenses may only be granted to applicants which are considered to have the requisite expertise, experience, resources and financial capacity". The applicants' environmental competence is therefore important when license applications are considered.

Other, more specific environmental requirements must be fulfilled before the licensee is allowed to commence activities. The Hydrocarbon Activities Act provides that the licensee must obtain a specific permit or approval before undertaking a particular operation. Thus, the drilling of a well is subject to approval by the authorities; cf. section 15(1). Part 4 of the Hydrocarbon Activities Act empowers the authorities to require the licensee, prior to the granting of the license, to submit an assessment of the environmental impact of the contemplated activities. The environmental requirements stipulated in the drilling approval depend on the conclusions of the assessment.

Furthermore, the licensee is under an obligation to use only approved drill mud. Section 30 in Royal Decree no. 646 on the Protection of the Marine Environment empowers the Faroese government (i.e. the Minister of Petroleum) to issue executive orders on the use of drill mud. To ensure harmonisation with international agreements, the entry into force of any such executive orders is subject to approval by the Danish Minister of the Environment. In the near future, regulations on the usage of drill mud will be issued by the Food and Environmental Agency, which is responsible for enforcing the Royal Decree on the Protection of the Marine Environment.

6.6. Impact on other community interests

Regarding the impact on other community interests, reference is made to chapter 5.3 of the report "Preparation for Oil Exploration", which envisages only a minor impact on the Faroese community in an exploration phase. But if the exploration activities are successful, the resulting field development and hydrocarbon production in Faroese waters are likely to affect many sectors of the community. The report therefore recommends that the period preceding any development and production phase, including the planned exploration phase, should be used to analyse the anticipated impact and draw up rational policies for counteracting it.

Research projects for which applicants for exploration and production licenses might offer support under clause 13(1) of the Model License may also include research into the oil industry's impact on the community. In light of the ongoing political debate on Faroese expectations from a future oil industry and the wish to avoid any negative impact on the community, it would be desirable if Faroese research institutions were given the opportunity to identify new important research subjects.

6.7. Stimulating effects on business and employment

The first licensing round is undertaken in the hope that it will generate revenue for the Faroese community, both directly, in the form of taxes and fees for the Treasury, and indirectly, as income earned by Faroese companies and individuals participating in the hydrocarbon activities.

At present, it is impossible to foresee exactly how the activities will affect the Faroese economy. Reference is made to chapter 4.6 of the report "Preparation for Oil Exploration", in which a number of potential scenarios are discussed.

The prospecting phase was not expected to contribute to any considerable degree to the Faroese economy. The main objective was to obtain knowledge and information in the hope of generating interest in the Faroese subsoil, thus making it a more valuable asset to the community.

The beginning of the exploration phase will mainly include additional investigations of the type undertaken in the prospecting phase, e.g. obtaining additional seismic data. At a later stage, a number of exploration wells will be drilled. Offshore exploration activities will mainly take place during summer.

In accordance with the Hydrocarbon Activities Act and the terms and conditions stipulated in the licenses, exploration activities will be based in the Faroe Islands. Equipment will be transported via a Faroese quay and personnel via a Faroese airport. This provision allows competition on equal terms between Faroese and foreign suppliers/manpower. The requirement for transport to take place via a Faroese quay is unlikely to generate any income for the Faroese Islands other than that associated with loading and unloading activities.

In due course, the requirement for Faroese companies to be used as suppliers, and to obtain know-how and links to the international oil industry, is expected to generate a variety of lucrative specialist industries. Similarly, the provision that the oil companies must employ and train Faroese manpower may increase employment opportunities for the Faroese workforce.

A different situation will arise if oil deposits are found. A substantial increase in activity and traffic can be expected in connection with the drilling of production wells, the development of oil fields and the possible construction of an onshore terminal. This will allow the operation of offshore installations and other production units to reach a consistent level, resulting in permanent workplaces for Faroese manpower and stable outlets for Faroese supplies. Oil discoveries will also encourage oil companies to step up their exploration activities.

A development phase, especially if it also involves developments on shore, may pose a risk of overheating the Faroese economy. Countermeasures would have to be taken to keep the demand for Faroese goods, services and manpower at a reasonable level during this limited period. If additional oil deposits are found and subsequently developed, the development phase and the consequent pressure on the Faroese economy might last for a longer, though still limited period.

Even though Faroese participation is encouraged, the demand for expertise in so many different areas, especially in the initial phase, will probably exceed the local capacity, meaning that a large share of both manpower and supplies are likely to be of foreign origin.

One of the purposes of the Act on Hydrocarbon Taxation is to ensure that foreign individuals and companies participating in offshore activities also pay taxes to the Faroe Islands. Some tax revenue can therefore be expected from the associated activities, already in the exploration phase.

If production is started, a certain amount of revenue will be generated in the form of royalties. However, no substantial tax revenue can be expected until production has reached break-even (after allowing for depreciation on development and exploration costs), and the oil companies begin to pay corporate tax on profits. In the longer term, if the companies are successful and profits exceed a certain level, they will also be liable to pay the special hydrocarbon tax.

7. Implementation of the first licensing round

This chapter deals briefly with the implementation of the licensing round following passage of the Bill on the First Licensing Round through Parliament.

7.1. Public notice inviting applications

After the passage of the Bill through Parliament and its subsequent enactment, a public notice announcing the initiation of the first licensing round will be inserted in one or more Faroese publications and in relevant periodicals and trade journals abroad. The Minister of Petroleum intends to open the licensing round immediately after the passage of the Bill. The period during which applications may be submitted is expected to be fixed at three months.

The invitation will contain a description of the areas offered for licensing, the general terms and conditions on which licenses will be granted and the main criteria for the granting of a license for the exploration for

and production of hydrocarbons. In addition, the invitation will state the requirements for the documentation, etc. to be submitted.

Both individual companies and groups of companies (consortia) may apply for licenses.

7.2. Conditions for granting licenses

According to section 6 of the Hydrocarbon Activities Act, licenses for exploration and production of hydrocarbons may only be granted to applicants that are considered to have the requisite expertise, experience, resources and financial capacity. The operator is to comply with the requirements as to technological expertise, while the consortium will be assessed as a whole with regard to the financial requirements. The Model License stipulates that if the license is granted to several parties jointly, they will be jointly and severally liable for any obligations to pay damages etc. Moreover, in determining to whom licenses are to be granted, the Minister of Petroleum must have regard to the extent to which the Faroese community will gain insight into and benefit from the activities carried on by virtue of the license.

Another condition that will be accorded great importance in the granting of licenses is the applicant's ability to attend satisfactorily to safety, health and environmental issues as well as to questions related to emergency preparedness; see chapters 5 and 6.5 above.

7.3. Selection criteria

In selecting the successful applicants among those fulfilling the basic requirements mentioned in item 7.2 above, the Ministry of Petroleum will first and foremost place emphasis on whether the proposed work programme and the attendant documentation demonstrate the applicant's willingness and ability to thoroughly explore for hydrocarbons in the area comprised by the license. As the presence of hydrocarbons can only be established by drilling wells, the Ministry of Petroleum will attach great importance to whether the working commitments agreed on with the applicant include drilling commitments.

In addition to the working commitments, the Ministry of Petroleum also intends, as described in more detail in chapter 4.4 above, to accord priority to the involvement of Faroese undertakings including the supply of goods and services, co-operation between companies, or employment opportunities or education and training schemes, cf chapter 4.2 above.

8. Administration etc.

The Ministry of Petroleum was established in August 1999 following the settlement on the continental shelf boundary between the Faroe Islands and the UK and the decision to license areas for hydrocarbon exploration.

The Ministry of Petroleum employs 12 persons and the Geological Department 11 persons. The Geological Department, which is part of the Faroese Museum of Natural History, also handles tasks other than those related to the Ministry of Petroleum. The preparation of the licensing round has required substantial external

expertise, and for this purpose the Ministry of Petroleum has received budgetary appropriations of an additional DKK 3 million for 1999 (the original budgetary appropriation for 1999 was DKK 6.35 million).

It is difficult to estimate the amount of revenue which the Bill on the First Licensing Round for exploration and production of hydrocarbons will generate. The revenue will depend on the success of the impending exploration phase; see chapters 4.3 and 6.7 above.

For processing applications, an application fee of DKK 100,000 will be charged per application. The licensees will have to pay an annual area rental, which will constitute DKK 500 per square kilometre during the first few years. These fees are discussed in more detail in chapter 4.3.1 above and will only generate limited revenue for the authorities. If, for example ten applications are submitted and the total licensed area constitutes 50% of the area offered for licensing of 14,000 square kilometres, the revenue from application fees and area rental will be DKK 4.5 million in 2000 and DKK 3.5 million in 2001 and 2002.

Depending on the number of licenses granted, hydrocarbon exploration will lead to an increase in the daily administrative tasks at the Ministry of Petroleum and the Geological Department. The number of employees is consequently expected to increase. However, before the outcome of the licensing round is known, it is difficult to predict how many man-years will be required.

Under the budget for the year 2000, the Ministry of Petroleum will receive net appropriations of DKK 9.63 million. The Ministry's revenue (application fees) is estimated at DKK 1.0 million, resulting in gross appropriations of DKK 10.63 million. The Ministry of Petroleum intends to draw on external expertise in connection with application processing; consequently, net appropriations may prove insufficient.

The budget for 2000 provides for net appropriations of DKK 3.927 million for the Geological Department. Revenue is expected to amount to DKK 1.596 million, of which approx. DKK 1.0 to 1.5 million will derive from services rendered by the Geological Department to the Ministry of Petroleum.

To some extent, the draft Bill on the First Licensing Round for exploration and production of hydrocarbons will affect the work of other authorities and institutions, for example in connection with the administration of the Royal Decree on the Protection of the Marine Environment, the Act on Hydrocarbon Taxation, etc.

NOTES ON THE INDIVIDUAL SECTIONS OF THE BILL

Notes on section 1

According to section 7(2) of the Hydrocarbon Activities Act, Parliament decides which areas are to be offered for licensing and lays down the general terms and conditions for granting licenses.

After the passage of a bill through Parliament, the Minister of Petroleum initiates the licensing round and grants licenses to the applicants who are considered to fulfil the conditions for the granting of licenses and who commit themselves to the most favourable work programme for the individual blocks.

Licenses are issued in accordance with the Hydrocarbon Activities Act, which regulates the granting of licenses for exploration and production of hydrocarbons, as well as all the phases of hydrocarbon activities, i.e. prospecting, exploration and appraisal, field development and production, and decommissioning.

Notes on section 2

As stipulated by section 7(2) of the Hydrocarbon Activities Act, the Bill defines the areas to be offered for licensing in the first licensing round.

Reference is made to the map attached as Schedule A and to section 4 of the general notes on the Bill.

Notes on section 3

As stipulated by section 7(2) of the Hydrocarbon Activities Act, the Bill establishes the general terms and conditions on which licenses for exploration and production of hydrocarbons will be granted. The Model License attached as Annex B sets out the general terms and conditions.

The standard terms and conditions will be common to all licenses. These terms and conditions will not be negotiable in connection with the awarding of licenses. However, if in the course of the first licensing round, weighty reasons are found for making minor adjustments to the general terms and conditions of the individual licenses, the Minister of Petroleum may incorporate such adjustments.

In addition to the general terms and conditions, exploration and production licenses will contain terms specific to the individual licenses. Unlike the general terms and conditions, the individual terms cannot be laid down until offers have been received and negotiations have been held with each applicant prior to the granting of licenses. Individual terms to be negotiated in the first licensing round concern the area comprised by the individual license and the work commitments of the individual licensee. Furthermore, some of the terms relating to Faroese participation in the hydrocarbon activities will be negotiated.

Several of the general terms and conditions incorporate an authorisation for the Minister of Petroleum to draw up more detailed rules and regulations. For example, clause 11(1) of the Model License provides that

the Minister of Petroleum may prescribe special procedures for the licensees' reporting on planned activities, as well as for inviting tenders and reporting on contractual relationships. In drawing up such procedures, the Minister of Petroleum will pay regard to legislation relating to commercial activities, trade policy agreements made with neighbouring countries, etc.

Eyðun Elttør
Minister of Petroleum

/Herálvur Joensen