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**The Norwegian Petroleum Sector and the Government  
Pension Fund – Global**

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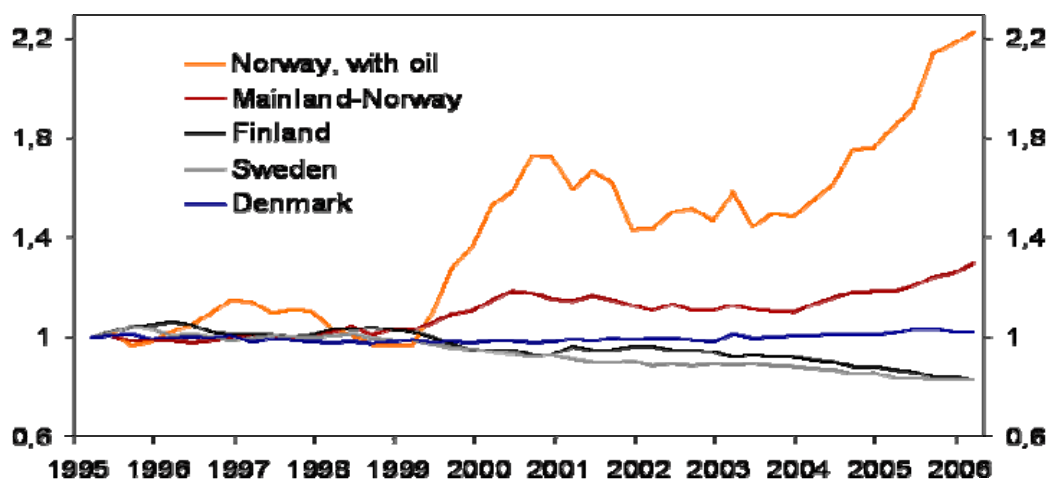
## 1 Introduction

The topic of this paper is the Norwegian experiences as a nation with large amounts of natural resources. In this regard Norway and Chile have something in common. As a background for the subject, let me start with a brief characteristic of Norway from an economic perspective.

Norway is a small, mountainous country with a population of only 4.6 million people scattered across a land area that is less than half the size of Chile. Norway's economic growth has been favourable for many decades, and the per capita income is among the highest in the world. An abundance of natural resources and openness to trade and capital movements are important reasons for this.

At present, globalisation and cyclical developments are boosting the Norwegian economy. Prices for our imported goods are falling relatively to prices for goods we export. Norway's terms of trade are improving. The impact of the rise in oil and gas prices is particularly strong, but the terms-of-trade gains for the mainland economy have been high as well.

*Terms-of-trade for goods. Norway and other Nordic countries*  
Index 1995 = 100



Nevertheless, in the face of such strong external influences, it is demanding to smooth developments in the Norwegian economy. Our stabilisation policy rests on some important pillars, which were established in the 1990s and in 2001 against the backdrop of the wide fluctuations in economic developments during the first twenty years of the oil age in Norway. Two important pillars are the oil fund mechanism and the guidelines for fiscal policy. A third important pillar is monetary policy. These issues are discussed in section 4 in this paper.

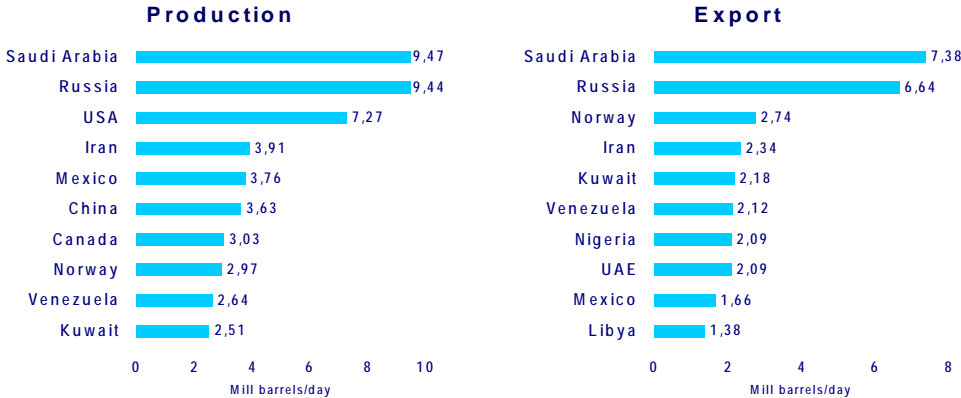
As an introduction to the issue the Norwegian petroleum sector and its importance for the Norwegian economy is described shortly in section 2. Appendix A gives an overview

over the Norwegian regulatory system of the petroleum sector and how the government take is organised in the sector to ensure that the resources benefits the society as a whole.

## 2 The Norwegian petroleum sector – history and prospects

Petroleum was discovered in the North Sea in 1969. Production began on 15 June 1971, and in the following years a number of major discoveries were made. Today, there are 50 fields in production on the Norwegian continental shelf. In 2005, these fields produced 3 million barrels of oil (including NGL and condensate) per day and 85 billion standard cubic metres (scm) gas, for a total production of saleable petroleum of 257 million scm oil equivalents (o.e.). Norway ranks as the world’s third largest oil exporter and the eighth largest oil producer. In 2004, Norway was the third largest gas exporter and the seventh largest gas producer in the world.

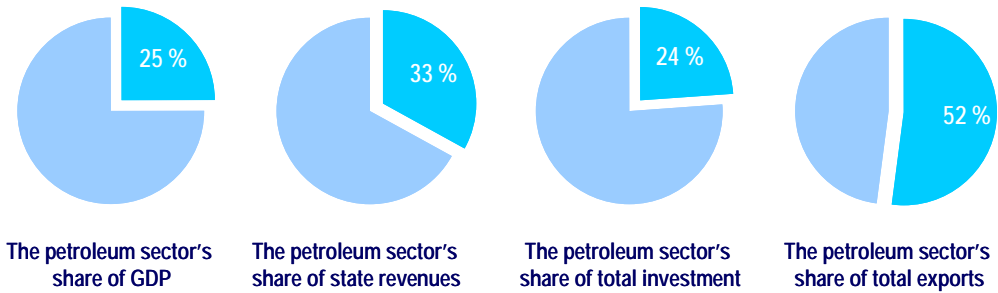
*The largest oil producers and exporters in 2005 (incl. NGL/condensate)*



*Source: Petroleum Economics Ltd.*

In 2005, the petroleum sector accounted for 25 percent of GDP in Norway. Through direct and indirect taxes and direct ownership, the state is ensured a high proportion of the values created from the petroleum activities. In 2005, the state’s net cash flow from the petroleum sector amounted to approximately 33 percent of total central government revenues. In 2005, crude oil, natural gas and pipeline services accounted for 52 percent of the value of Norway’s exports. Investment in the petroleum sector in 2005 amounted to 24 percent of total real investments in Norway. These figures vary from one year to another, and in 2005 they were relatively high due to the very high oil prices. People employed directly in the petroleum sector amount to only one per cent of total employment in our country.

*Macroeconomic indicators for the petroleum sector*

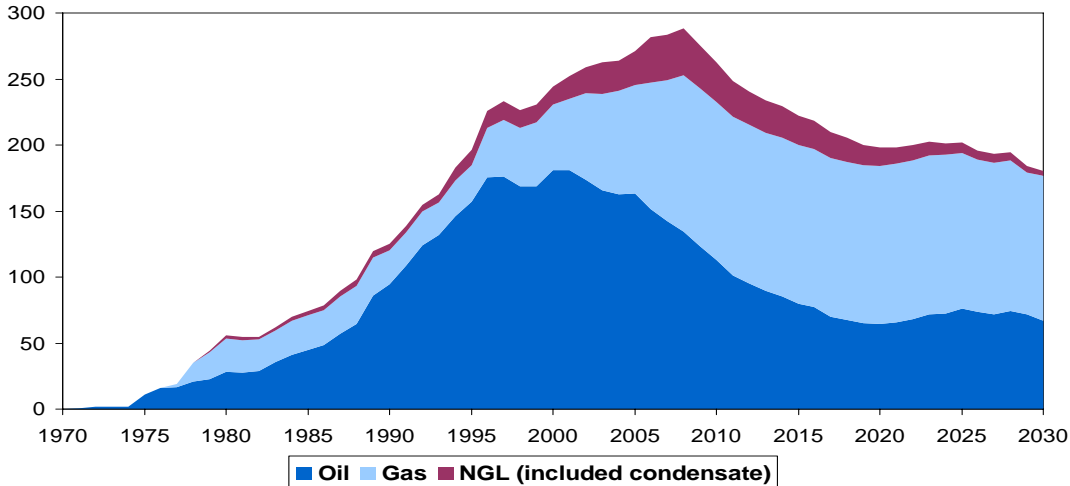


*Source: Statistics Norway, Ministry of Finance*

Approximately 30 percent of the expected total resources on the Norwegian continental shelf have been produced. The diagram below shows a forecast for future production from the continental shelf. It is based on the Norwegian Petroleum Directorate’s estimate of recoverable petroleum resources on the Norwegian continental shelf and presupposes that the authorities and the industry will implement the necessary measures to recover the remaining volumes. Petroleum production is expected to increase gradually up until 2011, and to fall gradually thereafter. While the crude oil production has already peaked, gas production is expected to increase until 2013. From representing approximately 35 percent of the total Norwegian petroleum production in 2006, gas production is likely to represent a share of more than 50 percent by 2013. In the longer term, the number and size of new discoveries will be a critical factor for the production level.

*Crude oil production in Norway has already peaked*

-Total petroleum production in Norway, mill. Sm<sup>3</sup> o.e.



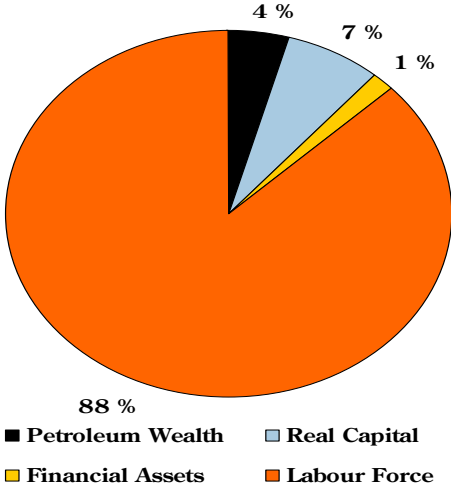
*Source: Norwegian Petroleum Directorate/ Ministry of Petroleum and Energy*

Even though petroleum is important to the Norwegian economy, its importance should not be exaggerated. Norway’s petroleum wealth (around (200) percent of GDP)

corresponds to only some 4–5 percent of total national wealth. In comparison, the value of human capital is close to 90 percent of total wealth. So reducing the size of Norway’s

*The labour force is our most important asset*

National wealth per capita



Source: Statistics Norway

labour force by 10 percent through longer vacation, shorter working hours, reduced retirement age, etc., could reduce future consumption possibilities by more than a drop in the value of Norway’s oil wealth to zero.

Clearly, maintaining the size of the labour force is a key economic policy challenge in the years ahead and the key lever to ensure both prosperity for the nation, and sound public finances. High petroleum revenues today must not distract us from keeping continuous focus on policies for flexibility and efficiency in order to enhance the economy’s production capacity.

The Norwegian regulatory regime and system for government take is described in Appendix 1 to this paper.

### **3 Fiscal policy guidelines and the Government Pension Fund – Global (previously Petroleum Fund)**

#### **3.1 Introduction**

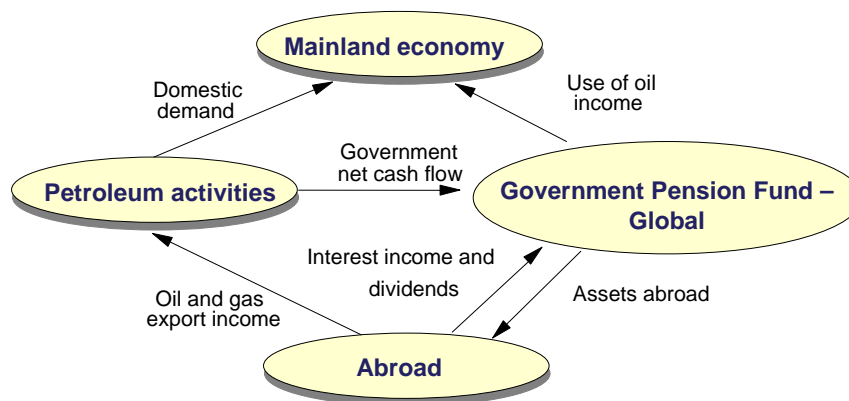
Today’s formulation of economic policy reflects the experience gained and the lessons learnt in the two first decades of the petroleum era, the 1970s and 1980s. At the time, Norway experienced wide fluctuations in economic activity. Inflation became high and variable. The fluctuations were reinforced by oil price shocks and the use of expected state revenues from oil production. Actually, we spent a large share of our expected petroleum wealth in the 1970s and 1980s. Welfare schemes were expanded significantly. The designed pension system implied immensely increasing liabilities as the system would mature and the population age. Current public spending crowded out

manufacturing industry. Domestic demand grew very rapidly, and a credit bubble developed. The bubble burst in 1986, simultaneously with a significant drop in oil prices. The consequences were severe with a recession that was deeper than would have been the case if we had maintained a larger and more competitive manufacturing sector. Norwegian industry lost export market shares in the late 1980s in spite of the booming conditions abroad and substantial capacity slack at home.

The experience of other countries that have received large, unexpected income from natural resources is not encouraging. Examples have showed us that easy money may lead to bad policies. It is very tempting to live comfortably on this income and be less concerned about safeguarding other revenue sources. In that case, the country is poorly poised to cope with an end to easy money.

The oil age in Norway has spanned 30 years and it appears that it will continue for many years ahead. Petroleum activities give Norway an economic base that is not available to many other countries. But it also presents us with challenges. The establishment of the Government Pension Fund and the spending guidelines for petroleum revenues together with the monetary policy regulation are intended to meet these challenges:

- First, revenues from petroleum operations differ in nature from other revenues to central government since their corollary is to some extent a reduction in central government petroleum wealth. We have an obligation to ensure that also future generations will benefit from the oil wealth. We have introduced budget policy guidelines that recognise the special nature of petroleum revenues: Central government's net cash flow from petroleum operations is transferred in its entirety to the Government Pension Fund - Global via the state budget, whereas the guidelines stipulates that only the expected real return on the Fund should be returned to the budget for general spending purposes. In this way the Fund serves as a long-term savings vehicle to let the Norwegian Government accumulate financial assets to help cope with future expenditures associated with the ageing of the population.
- Second, a steady, prudent phasing-in of petroleum revenues ensured by the budget guidelines is also needed in the interest of a balanced development of the Norwegian economy. The currency inflow from petroleum operations is substantial and uneven. If petroleum revenues were to be used as they accrue, this would lead to wide fluctuations in demand in the Norwegian economy. The budget policy entails predictable spending of petroleum revenues independently of current revenue flows. The Pension Fund – Global makes this decoupling of government spending from oil revenue flow possible. Moreover, investing a substantial portion of the petroleum revenues abroad through the Pension Fund – Global promotes exchange rate stability. Hence, there are important stabilisation policy and monetary policy rationales for the fund mechanism and the fiscal rule.



## **3.2 The Government Pension Fund – Global**

### 3.2.1 History

The Norwegian Government Petroleum Fund was formally established in 1990 when the Norwegian parliament (Stortinget) adopted the Act on the Government Petroleum Fund (Act of June 22, 1990, No. 36).

However, the fund mechanism entails that money will only be allocated to the fund when there is a budget surplus. In the first half of the 1990s there were budget deficits due to the strong recession. Only in 1995 was the budget back in surplus, and the first transfer from the state budget to the Petroleum Fund was made in 1996 for fiscal year 1995. After that the Fund has grown strongly. At the end of 2005 the Fund amounted to close to NOK 1400 billion (around USD 210 billion), or 99 percent of mainland GDP (i.e. excluding petroleum activities). Projections indicate that the Fund will grow to 180 percent of mainland GDP at the end of 2010. Given the present guidelines for fiscal policy, the Fund is expected to reach a level of around 250 percent of mainland GDP in the years after 2030, before starting to gradually decline.

In order to strengthen the public's sense of ownership of the Fund and make it easier to accumulate financial assets for the state, the Petroleum Fund was renamed the *Government Pension Fund – Global* as from 1 January 2006. The name change underlines the aim of the Fund to support savings for financing future pension payments. The pension system under the National Insurance Scheme will, however, remain financed over government budgets on an ongoing basis ("pay-as-you-go").

### 3.2.2 The Fund mechanism

The Petroleum Fund can also be seen as a fiscal management tool to ensure transparency in the use of petroleum revenues. In the work preceding the act establishing the Fund, it was emphasized that the Fund's resources must be included in a coherent budgetary process. When the Fund was established it was therefore

emphasized that the accumulation of assets in the Fund should reflect actual budget surpluses. This reflects an important point: running a budget surplus is the only way a Government can accumulate financial assets on a net basis. If a fund is set up with an allocation rule that is not linked to actual surpluses, the accumulation of assets in the Fund will not reflect actual savings.

*The Global Fund is integrated in fiscal policy*



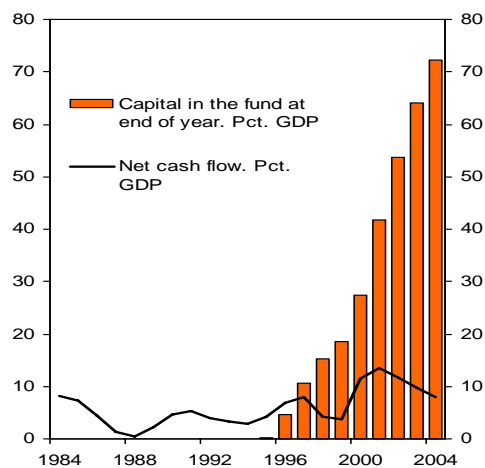
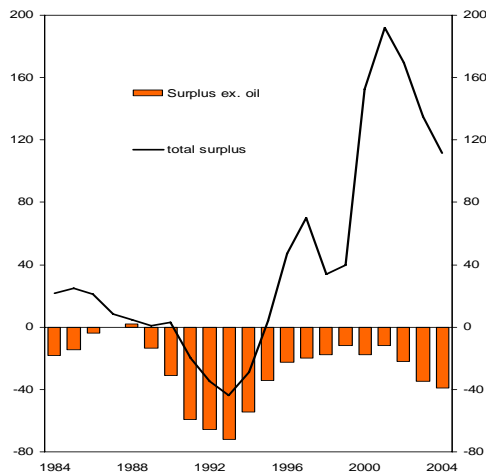
The interaction between the Pension Fund – Global and the fiscal budget is illustrated in the diagram above. The Fund's income is the central government net cash flow from petroleum activities (via the state budget), and the return on Fund investments is added to the Fund. The Fund's expenditure consists of an annual transfer to the Treasury corresponding to the amount of petroleum revenues used in the fiscal budget. The transfer from the Fund finances the non oil budget deficit. According to the fiscal guidelines, this should equal 4 per cent of the Fund's capital. In this way, money is accumulated in the Fund if, and only if, there is a Government budget surplus including oil revenues.

**3.3 Fiscal policy guidelines**

Norway has generally pursued a policy with general government budget surpluses. Only in the deep recession of the early 1990's the fiscal budget slipped into deficit for a few years. These were actually the only years after World War II when Norway had budget deficits on a general budget basis.

By the end of the 1990s, surpluses on the central government budgets were forecast to grow substantially due to increasing petroleum revenues. This made it evident for the government that we needed to establish some sort of formal fiscal guidelines in order to anchor the use of petroleum revenues. Experience from a number of countries demonstrates that it is difficult for government to accumulate financial wealth. The combination of large surpluses in government finances and the desire to increase appropriations within many areas makes it very demanding to pursue an economic policy that also attends to the long-term challenges relating to an ageing population.

*National Budget 2001 ... Large surpluses ahead ...*



*Source: Ministry of Finance, Norway*

On this background, the following fiscal policy guidelines were introduced 29 March 2001:

- The use of petroleum revenues over the Government budget should be gradually phased into the economy approximately in pace with an estimated 4 percent real return on the assets in the Pension Fund - Global.
- The actual implementation of fiscal policy should, however, also take into account business cycle fluctuations.
- The automatic stabilizers should have room to work.

Fiscal policy guidelines may be formulated in different ways. An important aspect is the existence of a rule per se. A theoretically possible rule could be to spend the real return on the petroleum wealth - "The Permanent Income Rule". The idea behind the permanent income rule is to maintain the real value of the petroleum wealth. This would, however, not take into account important risk factors, such as uncertainties to future oil revenues, growth in pension liabilities or the costs of restructuring of the economy. The permanent income rule would imply that we would have to borrow money to spend until oil is transformed into cash based on some volatile estimates of the oil wealth.

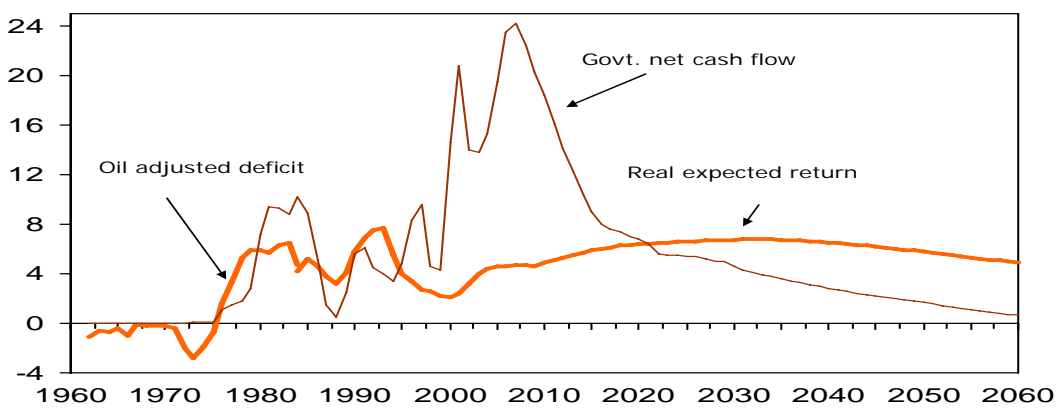
A spending rule based on annual expected real return on the Fund, as we have introduced, is a more cautious one than the Permanent Income Rule. Our budget rule has, as we see it, some attractive features:

- It is a simple rule, which is easy to communicate.
- It provides a clear reference for the budget process.
- It guarantees sustainability of fiscal policy under oil revenue volatility since the use of revenues is based on realized revenue flows from petroleum activities, and not on uncertain future revenues.
- It provides a common-sense solution to the intergenerational distribution question, since all generations will "harvest" their share of oil revenues through

spending the real return of the fund while the real value of the fund itself will be protected. (But since GDP is growing over time, the real return of the fund will of course constitute a lower share of total income in the future).

Petroleum revenues provide substantial, but uneven currency inflows into Norway. The currency flows might lead to a strong krone and large variations in the exchange rate. This tendency is, however, countered when the annual use of petroleum revenues over the central government budget is predictable and independent of annual revenue inflows, and the remainder is invested abroad. The fiscal rule and the capital outflow through the Pension Fund - Global contribute to both curbing the appreciation of the krone and maintaining its stability. This, in turn, helps us to keep an industry structure that can be sustained when oil revenues start to decline.

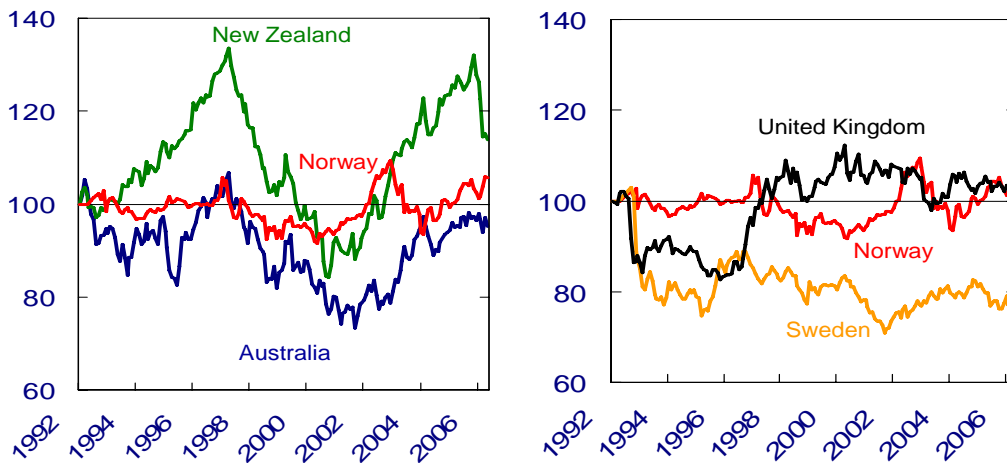
*From a fluctuating net cash flow to stable spending according to the fiscal rule  
Per cent of GDP for Mainland Norway*



*Source: Ministry of Finance, Norway*

The Norwegian krone does not stand out as particularly unstable when comparing with countries like Sweden, the UK, Australia and New Zealand, see diagram below.

*Nominal effective exchange rates*  
Indices. 1992 = 100

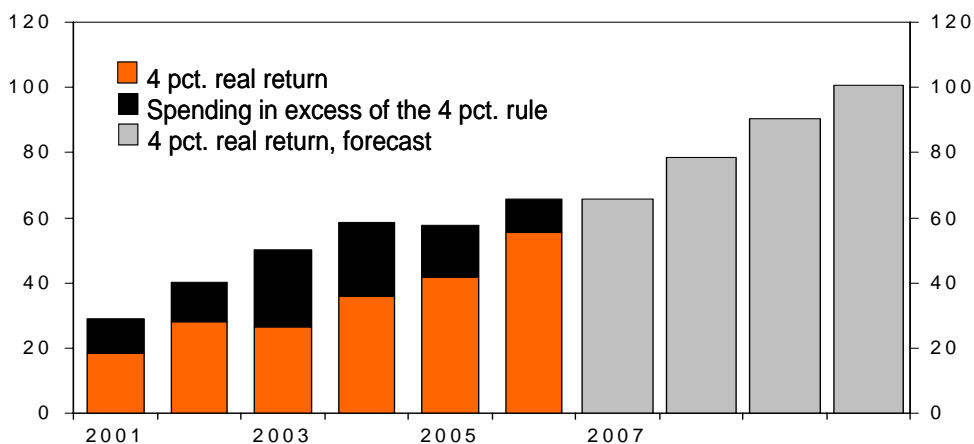


Source: EcoWin

For stabilisation policy purposes, the fiscal rule does imply some flexibility to the 4 per cent rule. Actual implementation of fiscal policy should take into account business cycle fluctuations. In addition, the automatic stabilizers should have room to work. The later consideration is taken into account by focusing on the non-oil *structural* deficit.

As it turned out, the flexibility of the fiscal rule was made use of already the first year of operation. Due to economic downturn internationally in 2001 and 2002, the capital of the Fund did not increase at all during 2002, in spite of transfers to the Fund from the Ministry of Finance of NOK 170 bn. In addition, the slowdown of the Norwegian economy in 2002 and 2003 both eroded tax revenues from mainland Norway and raised the unemployment expenditures. To stabilise the economy, spending above the 4 per cent rule was called for.

*Expected real return and the structural oil adjusted deficit*



Source: Ministry of Finance

In the period 2003 and up until now, spending of petroleum revenues has gradually declined and the estimated deficit for 2006 is now on par with estimated expected return on the Fund for 2007. We believe to be on track with the 4 per cent rule in the near future.

*Monetary policy*

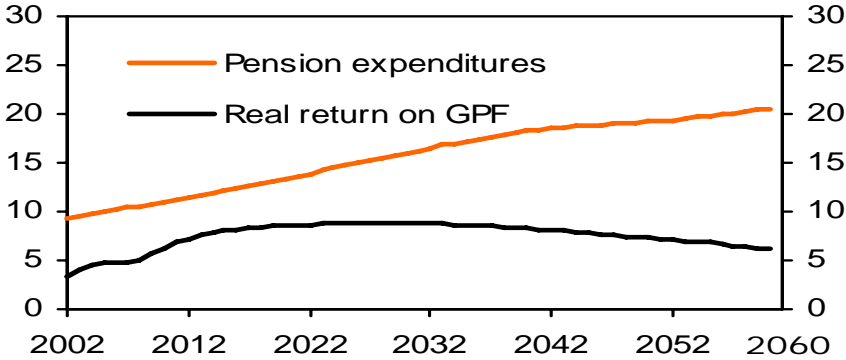
At the same time as establishing the budget rule in March 2001, a formal inflation target for monetary policy was introduced. The operational target for monetary policy is inflation of close to 2.5 per cent over time. The monetary policy regulation entails that Norges Bank, the Central Bank, shall operate a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment in interest-rate setting. Aiming fiscal policy more towards medium term objectives means that monetary policy has assumed greater responsibilities for regulating economic activity. A floating krone also has a stabilising effect, as the krone normally appreciates in good times and depreciates in bad.

*Long-term fiscal sustainability*

In 2006, the use of petroleum revenues over the Fiscal Budget is close to 4.5 percent of mainland GDP, as measured by the structural, non-oil budget deficit. The guideline for fiscal policy implies an estimated increase in the use of petroleum revenues over the Fiscal Budget of about 1/2-3/4 percent of mainland GDP in each year up to 2010, taking the non-oil budget deficit to about 5 1/2 percent of mainland GDP in 2010. Under present expectations the Fund is projected to increase relatively to mainland GDP for about 25 years. The accompanying increase on the real return will help financing increasing pension spending, but cannot alone solve the fiscal challenge arising from an ageing population, see diagram below.

*Income from petroleum will not suffice...*

Pension expenditure and expected real return on the Government Pension Fund - Global. Per cent of mainland GDP



Source: Ministry of Finance, Norway

### 3.4 Organisation of Pension Fund - Global

The Pension Fund Act states that the Ministry of Finance is responsible for the management of Pension Fund - Global. Norges Bank (the Central Bank of Norway) is given the task to operate the day-to-day management of the Fund on behalf of the Ministry of Finance. Norges Bank was chosen for several reasons, including the bank's knowledge of the constitutional set up and background for the Fund, the close relationship between the fund mechanism and monetary policy and Norges Bank's experience in managing its exchange reserves. The management of Pension Fund – Global is, however, not a Central Bank task and therefore strictly separated from Norges Bank's other activities.

When setting up the system for management of the Fund, there were three major requirements to be met:

1. **Professionalism:** In practice, this implied the need to ensure full use of the capabilities of Norges Bank, while also building skills and capabilities in the Ministry. It also implied extensive use of external fund managers for those assets that Norges Bank previously had little experience with.
2. **Accountability:** A system of checks and balances was set up to ensure accountability and a clear division of responsibilities between the Ministry and Norges Bank.
3. **Transparency:** This really is a key issue. The need to build a consensus for accumulating substantial financial wealth on the hands of the government, makes it necessary for policymakers to be able to tell the public exactly how the money is invested, and what the returns are.

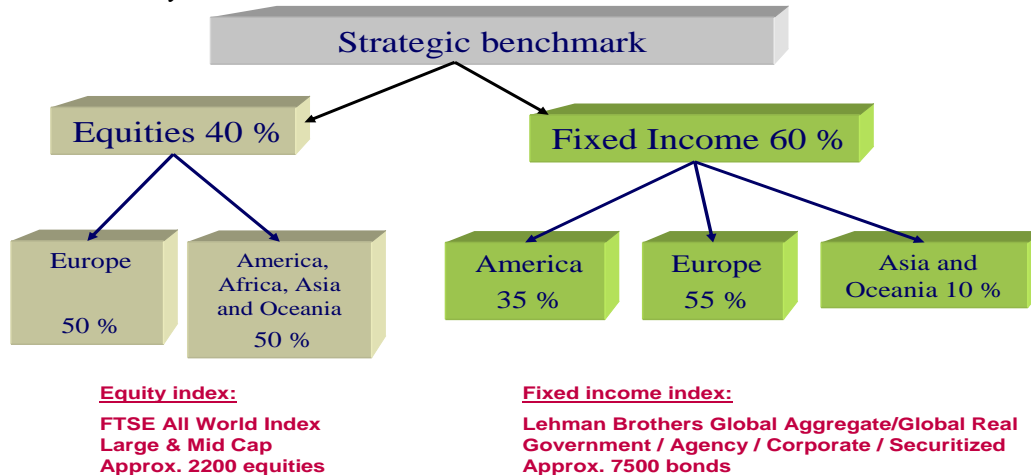
As the formal owner of the fund, the Ministry is responsible for defining the long-term investment strategy. This includes the strategic choices made in the management of the Fund regarding currency and country distribution, the distribution between asset classes and between securities in different market segments.

These strategic choices are reflected in a benchmark portfolio. This portfolio is a “virtual” fund, consisting of equity and bond indices for the various markets in which the Fund is invested. The benchmark serves two purposes:

- The Ministry has defined limits for the maximum variations permitted relative to the benchmark portfolio. The limit is defined as a maximum expected tracking error of 1.5 percent, which is a measure of the standard deviation of the difference between the return on the Fund and the return on the benchmark. Over time, this simply means that if Norges Bank utilizes the risk limit to the full, the return on the Fund will not deviate from the return on the benchmark portfolio by more than plus/minus 1.5 percentage points in two out of three years. The benchmark is thus an integrated part of the risk control system for the fund.

- The benchmark is also used to assess Norges Bank's performance. Actual returns are compared with returns on the benchmark portfolio and performance differences are reported and explained in the Fund's reports.

#### *Benchmark for the Pension Fund – Global*



The main objective of the management of the Pension Fund – Global is to invest the capital in such a way that the Fund's international purchasing power is maximised subject to an acceptable level of risk. The fund is exclusively invested abroad, spread over many countries and many companies. 40 per cent of the strategic benchmark is invested in equities and 60 per cent in bonds. This gives a diversified investment strategy for the Fund. Investing the Fund abroad promotes exchange rate stability.

In 2004, ethical guidelines were introduced for the Fund. The ethical guidelines consist of two types of instruments; *exercising ownership rights* and *excluding companies from the Fund*. The ethical guidelines are described in a more detail in Appendix 2 to this paper.

There are clear lines of responsibility between the Ministry of Finance and Norges Bank. Norges Banks operational management of the Fund must be within the guidelines and regulations set by the Ministry. In addition to the guidelines and regulations for the Fund, an agreement has been drawn up that regulates the relationship between the Ministry and Norges Bank in connection with the management of the Fund.

Formally, Pension Fund – Global is a deposit account denominated in Norwegian kroner at Norges Bank, owned by the Government. As such, it is a liability for Norges Bank. However, the guidelines state that Norges Bank is to acquire foreign securities in its own name for a value corresponding to the krone bank account. The return on these foreign investments, less Norges Bank's management fee, is defined as the return on Pension Fund - Global.

Norges Bank delivers detailed annual reports on the management of the Fund. These public reports describe how the Fund is managed and include a list of the companies in which the Fund's capital is invested at year end. The reports provide figures on total

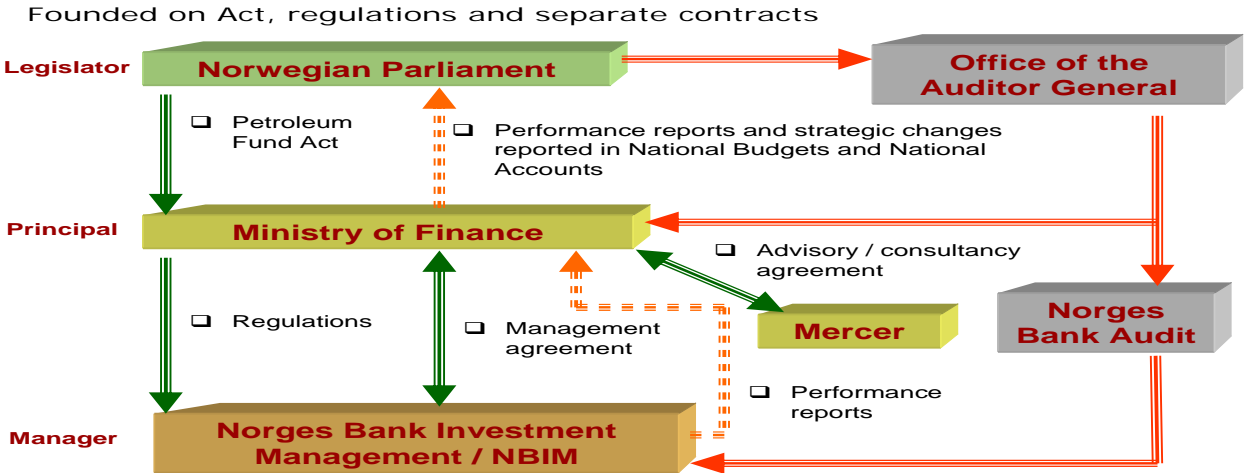
return, benchmark return, attribution of the excess return and management costs. The annual reports also contain articles on the investment philosophy behind the operational management, information on the process of selecting external managers etc.

In addition, Norges Bank submits quarterly reports containing the main return and cost data to the Ministry of Finance. Norges Bank also reports to an independent company hired by the Ministry to make calculations of Fund returns and attribution analysis of differences between actual and benchmark returns. The reports from this company are public, and are published on the Internet, as are also the reports from Norges Bank.

The auditing of the Fund and its management is done by the Office of the Auditor General. The Auditor General is appointed by and reports directly to Parliament, ensuring parliamentary control on Fund operations.

The management system outlined above is illustrated in the diagram below.

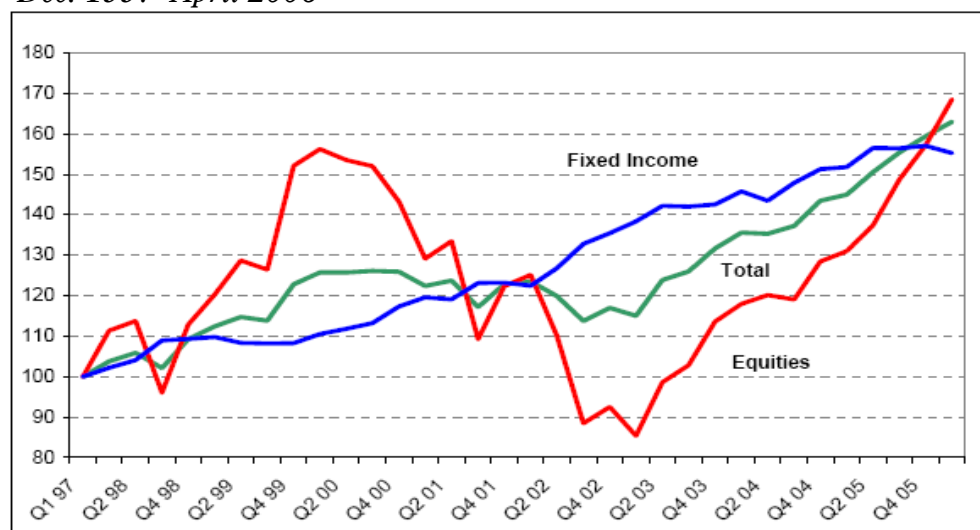
*Pension Fund - Global Governance Structure*



The diagram below shows cumulative return for the Pension Fund - Global since the beginning of 1998. The diagram also shows return for the fixed income and equity portfolios separately. In a large part of this period, the cumulative return on equity instruments has been somewhat lower than the return on fixed income investments, in particular due to losses in the equity portfolio in 2000 and 2002. The return on the equity instruments has also varied a lot more during the period.

The average real annual return in the period from January 1998 to April 2006 for the Fund was 4.5 percent.

*Cumulative Return on Equities, Fixed Income and on the Total Fund  
Dec. 1997- April 2006*



Source: Norges Bank

#### 4 Concluding remarks

Government revenues include large net cash flows deriving from petroleum, which gives us an economic base that is not available to many other countries. The petroleum sector does, however, also imply some main challenges to the Norwegian economy, both in the short term and in the long term.

The current macroeconomic framework, most notably the fiscal and monetary policy regimes and the oil fund mechanism, has been quite successful so far in shielding the Norwegian economy from excessive fluctuations. Putting aside parts of the petroleum revenues today will ensure that also future generations benefit from the petroleum wealth. However, even though accumulation of financial assets is necessary to cope with future expenditures associated with the ageing of the population, it is not sufficient. In this regard, the ongoing work reforming the pension system is important.

Structural policy is not the issue of this paper. Structural policies aimed at maintaining flexibility in labour, capital and goods markets are, however, probably as important as stabilisation policy to sustain both high growth and economic stability in the long term. Norway has managed to sustain productivity growth at a high level. Restructuring in the Norwegian economy in the 1990's, changes in the tax system, broader and deeper financial markets, and deregulation in trade and service markets appear to have resulted in a more efficient use of resources. Maintaining the size of the labour force is a key economic policy challenge in the years ahead and the key lever to ensure both prosperity for the nation, and sound public finances.

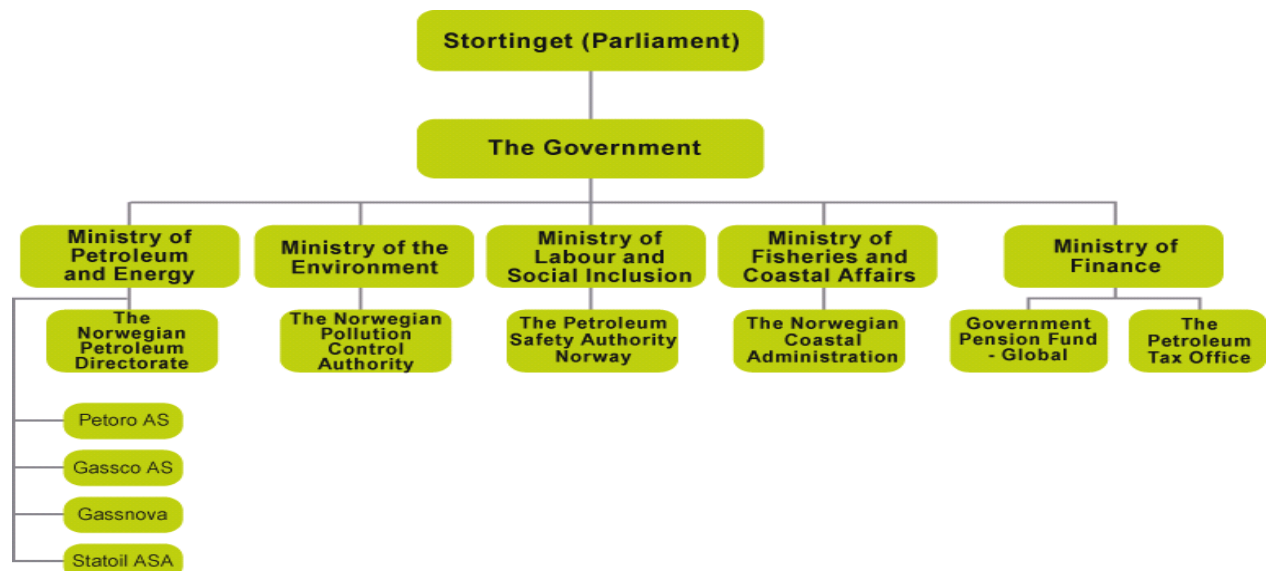
High petroleum revenues today must not distract us from keeping continuous focus on policies for flexibility and efficiency in order to enhance the economy's production capacity.

## Appendix 1 Resource management and government take

### A.1 Regulation of petroleum activities

In the early years following the discoveries of petroleum there were no Norwegian oil companies, and very few Norwegian institutions, public or private, with any knowledge of petroleum-related activities. At the time, the authorities chose a model in which foreign companies carried out all petroleum activities on the Norwegian continental shelf. Over time, the Norwegian involvement was strengthened by the creation of a state owned oil company, Statoil. Norsk Hydro, where the state had a 51 percent ownership share, also took part in the petroleum activities. A private Norwegian company, Saga Petroleum, was also established, but was later acquired by Norsk Hydro. As the various companies have possessed different technical, organisational and commercial expertise, both their cooperation and competition have been crucial for the development of the activities.

#### *National organisation of the petroleum sector*



In order for oil companies to make rational investment decisions, the framework conditions must be predictable and transparent. Organisation of the activities and the division of roles and responsibilities shall ensure that important social considerations are safeguarded and that the value created benefits society as a whole. At the same time, consideration for the external environment, health, working environment and safety plays an important role.

The Petroleum Act (Act of 29 November 1996 No. 72 relating to petroleum activities) provides the general legal basis for the licensing system which regulates Norwegian petroleum activities. The Act and its appurtenant regulations authorise the award of licences to explore for, produce and transport petroleum, etc.

The Petroleum Act establishes that the proprietary right to subsea petroleum deposits on the Norwegian continental shelf is vested in the state. Before permission for exploration drilling and production (a production licence) can be awarded, the area in question must have been opened up for petroleum activities. An impact assessment, covering such aspects as the environmental, economic and social effects of such activities on other industries and adjacent regions, must be carried out.

Production licenses are normally awarded through licensing rounds. The government announces a certain number of blocks for which an application for a production licence may be made. Applicants may apply individually or in groups. Production licences are awarded on the basis of impartial, objective, non-discriminatory and published criteria. On the basis of applications received, the Ministry of Petroleum and Energy puts together a group of companies for each licence or can make adjustments to a group which has submitted a joint application. The Ministry of Petroleum and Energy appoints an operator for this partnership, who is responsible for carrying out the day to day activities under the terms of the licence. There are no up front payments for licence awards.

The production licence regulates the rights and obligations of licensees in relation to the state. This document supplements the provisions of the Petroleum Act and specifies detailed terms for each licence. The licence provides an exclusive right for exploration, exploration drilling and the production of petroleum within the geographical area specified in the production licence. Ownership of the petroleum produced rests with the licensees.

## **A.2 The elements in the government take system in Norway**

### A.2.1 Overview

The instruments for the government take are taxes, the State Direct Financial Interest (SDFI), dividends from Statoil, CO<sub>2</sub>-tax, royalties and area fees. Taxes and the State Direct Financial Interest are by far the most important instruments and in aggregate the two accounted for approximately 95 percent of the total government take in 2005.

- The petroleum tax system in Norway is based on a net surplus taxation. All relevant expenses can be deducted to arrive at taxable net income. The first charge is the ordinary corporate tax of 28 percent which is applicable for all companies in Norway. After subtracting an investment based uplift (or extra depreciation), the adjusted net income is taxed at the Special Tax rate of 50 percent. The marginal tax rate on Norwegian Shelf income is thus 78 percent. There have been some changes in the tax system over time, but the main features from 1976 remain in place.
- Our overall experience with the Norwegian tax system is quite good. The system has fulfilled its primary task over time of securing income to the state from the petroleum activities. A crucial factor to the success of the tax system has been an

efficient tax administration and the stability of the system over time. The Norwegian Oil Taxation Office is very competent and has done an excellent job scrutinizing income returns from the oil companies.

- The State Direct Financial Interest is an arrangement whereby the state keeps an interest in a number of oil and gas fields, pipelines and onshore facilities. Each interest is decided when licenses are awarded, and the size of the state interest varies. As one of several licensees, the state pays its share of investments and costs, and receives a corresponding share of the gross income from the license. The SDFI was established on 1 January 1985 by splitting all of Statoil's interests in two, one direct financial share for the state (SDFI), and one which remained with Statoil.
- The SDFI has continued to take shares in the most promising licenses. The SDFI is, therefore, an important instrument for increasing the state's overall take in licenses with high expected profitability.
- Statoil was listed and partially privatised in 2001. In that connection, the administration of the SDFI portfolio was transferred from Statoil to a new state-owned trust company, Petoro. Petoro is funded over the state budget and does not spend any of the income from the SDFI.
- Currently, the state owns 70.9 percent of the shares in Statoil. As an owner of Statoil, the state receives dividends. In 2005, dividends to the state from Statoil amounted to 8.1 billion NOK or approximately 3 percent of total government take in 2005.
- As from 2006 the royalty system has been abolished. However, it is worthwhile mentioning that royalties were a very important instrument in the early stage of the development of the Norwegian shelf. It provided early income to the state and was fairly easy to administer. At the time, there were some doubts about our ability to establish an effective tax system and an effective tax administration. Royalties was the most important instrument. Depending on the field's production volume the royalty rate could be as high as 16 percent for oil.
- The CO<sub>2</sub> tax was introduced in 1991 with the objective of reducing emissions of CO<sub>2</sub> from the petroleum activities.
- The area fee accrues to all production licenses after the expiry of an initial period. The fee is intended to encourage return of acreage that companies do no longer wish to exploit.

Looking back, developments in the government take system have steadily moved towards reduced reliance on gross income and volume. Today, all important elements

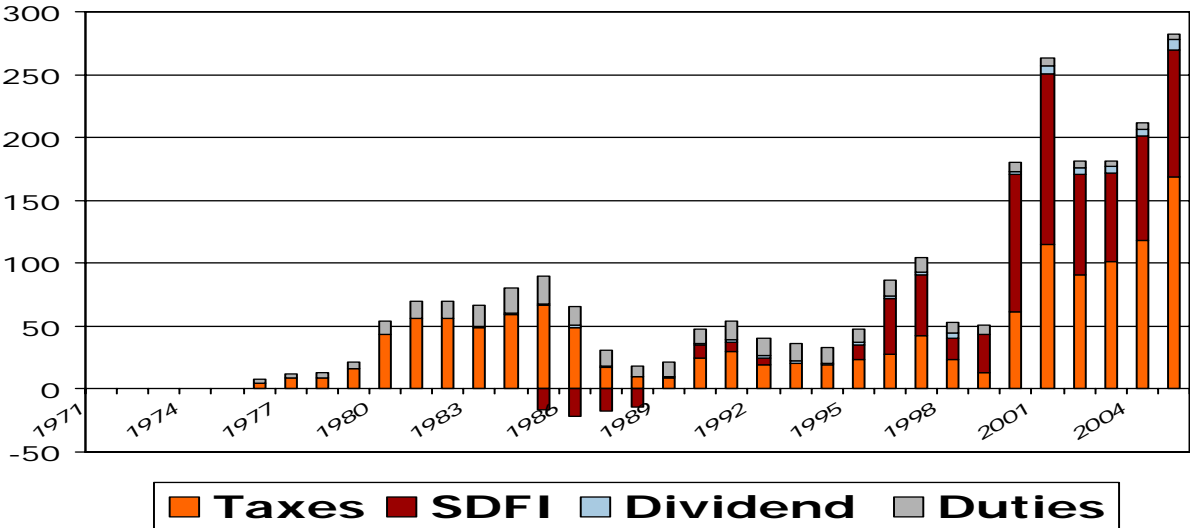
depend on net income. At the same time, and mirroring this, the state is now assuming greater economic risks. This is particularly apparent in the SDFI.

All proceeds in the government take system flow into the Pension Fund – Global (previously Petroleum Fund), formally via the state budget. In addition, proceeds from sale of government owned shares in Statoil and sales of SDFI interests are also channelled to the fund.

A.2.2 Total government take composition

The diagram below shows the total government take from the petroleum sector since 1971. Until the beginning of the 1990’s taxes and royalties were the most important instruments. Duties in the figure include royalty, CO<sub>2</sub>-tax and area fee.

*Total government take. Bn 2006-NOK (1 NOK = 0,16 USD 26 May 2006)*



*Source: Ministry of Finance, Norway*

When the SDFI was created in 1985, the investment costs in new fields exceeded the income from producing fields in the portfolio. The net income from the SDFI did not reach substantial levels until 1996-97, that is about 10 years after the creation of the SDFI. In 2005 SDFI accounted for approximately 35 per cent of total government take.

2005 is the last year in the diagram with a cash flow of 275 billion NOK. Estimated cash flow in 2006 is 348 billion NOK.

A.2.3 Lessons to be learnt

As a new oil nation, Norway faced major challenges of securing expertise, technology, organisation and controls, methods of obtaining revenue and developing the oil and gas

industry as well as the supply industry. These tasks were formidable and all possible instruments were put to use. Legislation, licensing policy and state participation in oil and gas operations formed the cornerstones. The development of the sector was crucially dependent on foreign capital, technology and expertise and from a value creating point of view it is extremely important that leading foreign oil companies continue to play a role in Norway.

The challenge is to organize the petroleum activities so that the welfare for society is maximised. There is no standard method as to how this can be achieved. An organisation of the activity that works well in one country does not necessarily work well in another country. The underlying principles of transparency, accountability, state governance and control and creating value are, however, important in any organisation of the sector. It should also be born in mind that markets and circumstances change. Thus, the best organisation of the petroleum sector may change over time. This is an argument in favour of retaining flexibility for change.

In organising the sector, an important question is how large economic risks the state is willing to assume. Attitudes towards risk may influence the design of the government take system. State ownership holdings in production licences and taxes levied on net income imply that the state is highly exposed to economic developments in the sector.

In establishing a petroleum sector, priority should be given to building of authorities' competence and powers to control and guide how the nation's resources are exploited. It is important that the regulatory role remains firmly vested with the authorities.

In sum, the Norwegian authorities have been successful in ensuring that the bulk of petroleum wealth benefits society as a whole. Both the state's ownership interests through the State's Direct Financial Interest in petroleum activities (SDFI) and the tax system have contributed. The companies that extract oil earn a reasonable return on their investments and have incentives to invest, but the economic rent has essentially accrued to the general public.

## Appendix 2 Ethical guidelines for Pension Fund - Global

Ethical guidelines for the management of Pension Fund – Global were introduced in 2004. The guidelines build on a proposal from an independent commission appointed by the Government. The Commission pointed at two main ethical obligations for the Fund; firstly, the obligation to ensure financial returns so that future generations will benefit from the oil wealth, and secondly, the obligation to respect fundamental rights for those who are affected by the companies in which the Fund invests. With a view that long-term returns should benefit from adherence to generally accepted norms of ethical behaviour, there is no contradiction between these two obligations.

What then are these “generally accepted norms of ethical behaviour”? Norway is a pluralistic society and there is no consensus on one particular uniform ethical perspective. The commission thus stated that ethical guidelines should be based on some main normative characteristics and anchored in widely recognised standards. The conventions and principles laid down by international organisations such as the UN, OECD and ILO make out such a consensus as they define what should in the least be required by companies regarding fundamental rights and protection of the environment, human life and health.

We promote the ethical foundation through two types of instruments; through *exercising ownership rights* and through *excluding companies from the Fund*.

- In cases where it is possible for the Fund to encourage a company to put in place systems which will reduce the risk of ethical infringements, the use of ownership rights is the preferred option.
- In other cases, however, there will be no realistic hopes of changing grossly unethical practices. There are also activities which are unacceptable to the Fund per se. In these cases, we believe the only way of avoiding complicity in grossly unethical activities is by disposing of interests in the company in question.

One might say that we hope not to find too many companies whose activities would warrant exclusion according to the guidelines. We would like to spend efforts trying to influence and take part in processes that will raise ethical awareness among investors and improve the ethical standard in the companies where the Fund is invested as well as in the business community at large.

Norges Bank carries the responsibility of exercising ownership rights. In accordance with the ethical guidelines, Norges Bank has laid down new principles for corporate governance and has established a Corporate Governance team to build up corporate governance activities and strengthen the ethical dimension of portfolio management.

The exclusion mechanism is a defensive measure aimed at avoiding a situation where the Fund runs the risk of being complicit in ethically unacceptable practices. There are two sub-categories of exclusions. The first category, negative screening, aims at ridding the Fund of all companies that produce weapons that through their normal use violate fundamental humanitarian principles. The second category of exclusions pertains to

seriously unethical conduct on the part of the company. The aim is that the Fund should not bear an unacceptable risk of contributing to violations of fundamental humanitarian principles, gross violations of human rights, gross corruption or severe environmental damage.

The Ministry of Finance has established an independent Council on Ethics, which gives recommendations on possible exclusions based on the ethical guidelines. The decision to exclude a company lies with the Ministry. Seventeen companies have been excluded from the Government Pension Fund – Global based on recommendations from the Council on Ethics. Most of these companies were excluded because of their involvement in the production of “inhuman” weapons, such as anti-personnel landmines, cluster weapons and nuclear weapons. Before the Council concludes a case, the company is given an opportunity to comment on the basis for the Council’s advice to the Ministry.

We see it as important and necessary to have transparency also concerning the ethical guidelines and how they are put into practice. Norges Bank reports on the exercise of ownership rights in its annual reports to the Ministry of Finance. These are made public. Recommendations from the Council on Ethics are also made public, as well as decisions from the Ministry to exclude certain companies from the Fund. Decisions to exclude, and the underlying recommendations, are made known to the public only after disinvestment has taken place in order to secure a financially sound disposal of the Fund’s securities.