



## **SPECIAL REPORT: The Future of Somalia Oil & Gas Exploration**

Somalia is not alone when it comes to stories of vast resources underfoot waiting to be discovered. As with many similar countries and pastoralist areas, these rumours may involve a relative having seen gemstones sparkling in the rocks or oil seeping from the ground like water, and the stories have passed through generations as truth. Oil and gas companies often perpetuate these myths through forward looking statements such as, “*USGS estimate total Undiscovered Resources of 16 billion barrels of oil and 260 Tcf gas in provinces bordering Soma Oil & Gas Offshore Evaluation Area in Somalia offshore waters*”<sup>1</sup> or “*The Dharoor and Nugaal valley concessions have themselves been independently assessed to potentially contain over 19.9 billion barrels of oil in-place.*”<sup>2</sup> So what does this all mean; are there really recoverable amounts of oil underfoot that can help develop the country, and what can Somalia do to encourage this sector investment and development?

### **What is a typical oil and gas exploration company who may choose to explore in Somalia?**

*"Where oil is first found is in the minds of men" Wallace Pratt, 1885-1981*

To discuss the prospect of oil and gas exploration in Somalia, it is important to understand a little about the companies who undertake exploration activities. One of the most common misconceptions is that majors such as Chevron, Conoco and Shell, who all declared force majeure at the onset of the 1991 Civil War, are all lining up to re-enter Somalia and the oil/money will be flowing a soon as they return. While some of these companies may be in discussions with members of the Somali diaspora or representatives from the Federal Government of Somalia (FGS), it is unlikely majors will return in the immediate future, especially to land-based exploration activities. A more likely scenario, considering the risk, is for small independent oil companies to undertake oil and gas exploration activities to de-risk the country in search of hydrocarbons.<sup>3</sup>

Prior to the start of exploration, a company must sign a Production Sharing Agreement (PSA) with the host government, defining boundaries of the exploration area, obligations, and terms for revenue sharing between the company and the host government should there be a recoverable discovery. All of the risk and expenses of exploration are the responsibility of the company conducting the exploration activities, with the understanding that ‘IF’ they are successful in recovering oil or gas, that the exploration company’s expenditures will be recuperated at a percentage outlined in the original agreement and based on the amount of recoverable hydrocarbons.

While this all sounds simple, it is important to understand that there are many expensive phases of exploration before a well is drilled, often beginning with environmental impact studies, surveys and assessments, aerial gravity surveys, ground based seismic surveys, and much more. The intention is to narrow down the prospect for drilling to areas with greatest potential, as each onshore exploration well in Somalia will cost approximately USD 30-50 million as a rough figure, and the chance of discovering recoverable hydrocarbons is extremely low.

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<sup>1</sup> <http://www.somaoilandgas.com/images/content/somalia%20oil%20%20gas%20summit%2020%20oct%202014%20final.pdf>

<sup>2</sup> <http://www.brandonhillcapital.com/media/3939/Red%20Emperor%20Resources%20Initiation%2030th%20November%202011.pdf>

<sup>3</sup> Small independents are generally comprised of core investors or leadership with oil and gas technical experience, often gained from working with larger independents or majors. The investors typically form a corporation traded on an international stock exchange to help raise funds for exploration activities based on the depth and experience of their teams, investor confidence, and how well they sell the company and concept. The share price generally starts low as a penny stock, and may increase depending on the quality of the concession and agreement signed with the host government, and progressively with future stages of exploration activity and other market factors.

## **What factors will an oil and gas company consider when investing in a country like Somalia?**

*"First look at the size of the prize and then the risk involved - Geology first, Economics second" R.E.McGill-*

So why take a risk in a country like Somalia? The answer to this question is based on many factors beginning with geology, and ultimately factored against the risks and costs of exploration activities. Simply put, when the risks and costs outweigh the potential benefit, a company will look for an easier place to do business. When calculating the risks in Somalia, one must not only consider terrorism and the ongoing insurgency, but government, legality of licenses issued by regional states, corruption, navigating United Nations sanctions imposed on the country, as well as internal clan and border issues, just to name a few.

While some recent exploration activities have taken place offshore, and in the northern regions of Puntland and Somaliland, there are parts of the Central and Southern Regions of the country which are still no go areas for the Federal Government, as well as internationals working for aid and development agencies, due to the al-Qaeda linked militant group al-Shabaab who still control large portions of the country. The AMISOM-led offensive has seen progress over the past 6 months with highlights such as allied forces targeting and killing senior leaders, including al-Shabaab's previous leader, Ahmed Abdi Aw Mohamed 'Godane', as well as the group's head of intelligence wing or 'Amniyat', Abdinasir Hassan Barakow 'Tahlil', and the head of external operations and senior member of Amniyat, Abdi Nur Mahdi 'Yusuf Dheeq', in separate drone strikes. Puntland forces have re-taken portions of al-Shabaab's northern stronghold in the Galgala Mountains, cutting key supply and safe havens, as AMISOM forces are continuing to advance on several key cities and villages in the South Central Somalia. The offensive has seen some limited and sporadic fighting with militants often conducting strategic withdrawals from areas prior to the main advance. Particularly in the south, the militants' tactics have evolved into asymmetric warfare with regular attacks and blockades on key supply lines and allied bases. Following attacks, the militants often blend into the local population and forests, supported through pre-established networks, making capture and defeat particularly difficult. While in many ways al-Shabaab has been weakened through attrition, capture and surrender, they are by no means defeated, and continue to conduct coordinated attacks and assassinations against strategic targets and officials throughout the country. Internationals and foreigners, including humanitarian organisations, will continue to be at risk of attack and their personnel for kidnap for ransom throughout most parts of the country. As well as ongoing low-level attacks, it is possible that the militants may attempt to launch a coordinated attacks against key government installations, which could put any exploration activities at risk of potential direct or indirect attack.

There have also been positive political gains in the country with a national constitution passed on June 23, 2012, and the Federal Government of Somalia established on August 20, 2012, following the end of the interim mandate of the Transitional Federal Government. Local state governments officially recognised as Federal Member States have a degree of autonomy over regional affairs and maintain their own police and security forces. The Somaliland region operates as an independent nation state but has had no international state recognition in this capacity. To this end it has issued block licences and signed a number of mining and oil and gas exploration agreements with private companies. The Puntland State of Somalia operates as an autonomous regional administration with no desire to break away from Somalia, however relations with the FGS have at times become strained, particularly with regards to the sharing of resources. Puntland has also signed its own exploration agreements, both before and after the formation of the FGS. A recent statement by FGS announced that only it can issue licences to oil and gas operators and declared any licences issued by Somaliland or Puntland void. On January 29 in their Quarterly Report, Red Emperor, a JV partner with Horn Petroleum with PSAs for Dahoor and Nugal Blocks in Puntland, announced that due to the FGS position they would be "closing down its office in Bosaso and releasing its entire staff. In addition, all contracts will be terminated, with exception of the production sharing agreements ("PSAs"), but including those for the lease of the villas and the lay-down yard, with all remaining inventory in Puntland being disposed of or sold. The aim of these actions is to reduce the JV's cost exposure until there is clarity and contractual certainty around the

PSAs and the legal regime that currently exists in country. The JV has proposed that the Puntland government offers it a two-year extension to both PSAs, free of any consideration, so that we may work together to properly establish the environment required for further investment in this exploration program.”<sup>4</sup> There is a current dispute between Somaliland and Puntland regarding regional borders of Sool, Sanaag and Cayan impacting competing licenses issued to international exploration companies by Somaliland and Puntland. The FGS in a September 01, 2014 Press Release accused international oil and gas exploration companies of destabilising the country by signing overlapping oil contracts and striking deals with regional governments, warning the Somali government will lodge complaints with their respective countries and the United Nations Security Council.<sup>5</sup> The current political and security environment in the country indicates it is unlikely that the FGS will be able to operate with effective administration and control over its territory, especially Somaliland, in the foreseeable future.

In addition to these regional issues and disputes, Somalia and Kenya disagree over the boundaries of their respective exclusive economic zone (EEZ) in the Indian Ocean. Somalia claims its maritime boundary lies perpendicular to the coast, while Kenya claims the maritime boundary extends horizontally from its border with Somalia. Both countries have submitted their claims to the UN and both countries recognise the jurisdiction of the International Court of Justice (ICJ). At the beginning of June 2014, Soma Oil and Gas Exploration completed Somalia offshore seismic 2D acquisition programme. The findings of the seismic survey may pave the way for offshore oil and gas exploitation at the beginning of 2015 and may see additional investor interest in offshore blocks, potentially bringing vital revenue to help strengthen government structures and wider development to Somalia. Kenya has already awarded a series of concessions of offshore blocks in the disputed zone to Total, Eni, Anadarko and Statoil. This has led most of the companies to limit their operations to the Kenya side of the disputed boundary line. An ICJ ruling in favour of Somalia would allow it to award concessions and would impact on existing contracts which may lead to some companies seeking refunds from the Kenya government. On the other hand, if the ICJ rules for Kenya, then this will enable companies to expand exploration operations. Either way, the ruling will provide certainty and may increase investor interest in offshore blocks. There may also be challenges to offshore oil and gas exploration in these areas due to the potential security threats posed by pirates, local criminal networks, and possibly al-Shabaab, who may seek to exploit vulnerable offshore exploration activities.

International exploration companies also face potential compliance issues regarding the US Foreign Corrupt Practices Act (FCPA) or UK Bribery Act 2010.<sup>6</sup> Additionally, the United Nations Security Council imposed a general and complete arms embargo on Somalia through resolutions 751 (1992) and 1907 (2009) concerning Somalia and Eritrea.<sup>7</sup> This embargo has been modified through several resolutions over the years to cover direct and indirect supply of weapons, military equipment, technical assistance, training, financing and other assistance, related to military activities, or the supply of arms, which makes it nearly impossible for an exploration company to operate in Somalia without being in breach of the embargo.

Another reality facing oil companies from large to small is the fall in oil price from over USD 100 per barrel just a few months ago to around USD 55 at the writing of this report; the impact is being felt throughout the industry.<sup>8</sup> Some

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<sup>4</sup> <http://www.redemperorresources.com/IRM/ShowDownloadDoc.aspx?SiteId=248&AnnounceGuid=213f8623-16ee-4987-b521-9dc7e71b33db>

<sup>5</sup> <http://cdn.wardheernews.com/wp-content/uploads/2014/09/Press-release-Somalia.pdf>

<sup>6</sup> Transparency International's 2014 Global Corruption Report ranked Somalia 174/175 with North Korea at the bottom of the list as one of the most corrupt countries in the world. <http://www.transparency.org/country#SOM>

<sup>7</sup> <http://www.un.org/sc/committees/751/>

<sup>8</sup> Some analysts blame Saudi Arabia and OPEC for continuing to supply the market and driving down prices in attempt to halt shale gas exploration and potential energy independence in the United States. Others point to the United States and a global conspiracy against Russia to further impact the Ukraine sanctions.

analysts see the market levelling out within the year, while others believe the prices may remain low for the next several years, which will greatly impact any potential for near term Somalia exploration activities. Shell has recently announced plans to cut investment by USD 15 billion over the next three years as the crash in oil prices saw fourth-quarter profit miss forecasts. Tullow Oil in Kenya is reportedly making plans to draw down from four exploration rigs operating in Turkana, to just one operational rig in the coming months and cutting thousands from the local and international workforce supporting Kenya operations. However, global exploration activities will not stop but rather companies will look to become more efficient, perhaps less risk averse and more selective in where they choose to do business, and explore for oil.

### **What can the Somali Government do to encourage investment in oil and gas exploration?**

*"In a few decades, the relationship between the environment, resources and conflict may seem almost as obvious as the connection we see today between human rights, democracy and peace." Wangari Maathai*

#### **1. There must be a clear and transparent resource sharing agreement between the FGS and regional states.**

There are just two regions of Somalia with relative peace in comparison to the chaos and war plaguing the country, Somaliland and Puntland. Somaliland has seen international aid and development, primarily through the United Kingdom and various social and security development programmes. Puntland has also seen aid and development support through various international development agencies, but on nowhere near the scale as Somaliland.

Since its inception in 2012, the FGS has received the majority of donor funding for the country, however regional states have seen little, if any, direct support from the FGS. The Puntland region's revenue is almost entirely dependent on income from tax generation through the port and airports, which has at times left the state unable to pay salaries for civil servants, including security forces. For this reason, regional states are sceptical regarding FGS instructions that all PSAs must be negotiated and paid to the Federal Government of Somalia, and it is essential for a clear and transparent resource sharing agreement to be implemented.

#### **2. The international community must encourage Somaliland to join the federal process.**

Somaliland declared independence from Somalia in 1991, although the self-proclaimed independence remains unrecognised by any country or international organisation. The relative stability of Somaliland in comparison to greater Somalia since the civil has allowed for implementation of aid and development programmes with direct international support, which many locals assumed could also lead to independence. With the formation of the FGS in 2012, independence appears unlikely, and in many ways counterintuitive to the goal of rebuilding a stable and secure country. As the primary benefactor to Somaliland, the UK Government clarified this position during a February 09, 2012 House of Commons debate on Somalia,<sup>9</sup> and the position of the UK Government has not publically changed. However, some international organisations continue to pursue separate agendas with greater Somalia and Somaliland, which continues to confuse the federal process and may ultimately inhibit foreign investment.

#### **3. Oil exploration must be seen as a long term investment for the benefit of the Somali people and between the FGS, Regional Governments and the exploration companies.**

The term 'resource curse' is often used in relation to oil and gas exploration in developing countries, however the 'Somali curse' of clan and political infighting, corruption and greed may supersede this potential problem. Experts agree Somalia and Yemen have similar geology and the likelihood for hydrocarbons is good, although oil has not yet been discovered. To do so will require a substantial investment from international oil

<sup>9</sup> <http://www.publications.parliament.uk/pa/cm201212/cmhansrd/cm120209/debtext/120209-0002.htm#12020952000002>

and gas exploration companies, patience and cooperation from the people of Somalia, support from the FGS, Regional Governments, the International Community, and a lot of luck. The current estimates being discussed by some individuals stating Somalia will be an oil producing country in the next six years are not at all realistic, especially considering there have been no discoveries of recoverable hydrocarbon to date. Oil and gas exploration programmes require several years before a first well is drilled, with a low chance of discovery, as noted in Puntland with the two wells recently drilled and not yet discovering recoverable hydrocarbons. A realistic timeframe from discovery to production is approximately 7-10 years, and once production begins and the oil is sold on the market, the money invested by the exploration company must be repaid as per the PSA. This is where corruption or often inflated costs of doing business come back to haunt many countries as they suddenly begin to question why regular services were charged out to the company at several times over the real cost of doing business.

Somalia as a nation must look at oil and gas exploration as a long term investment for the benefit of all. The Somali 'live for today' way of doing business must be set aside and international corporations, who may consider investing in the country, considered as partners. In today's business world, graft and corruption are not acceptable to reputable companies, and only reputable international corporations can afford to risk the money involved in oil exploration. When internationals come to work in Somalia, they must be protected by the communities in which they work as most companies have some risk appetite, but a major incident could cause an entire project to stop, impacting the nation as a whole. The early days of exploration may see hundreds or more employed for a short period of time but, if successful, it could mean work for entire communities for generations to come. In the early days of an exploration project a community will not become rich, but those who are employed will spend money in the local economy, further assisting those not directly supporting the project. Furthermore, if Somalia is fortunate enough to discover oil, the impact will be felt throughout the nation through potential income and job creation a discovery may bring.

This concept must be understood by all, and especially by the country's leadership, who are often the only point of contact for exploration company's early assessments. The nation's leaders must educate their communities on the importance of this investment to ensure patience and cooperation from all for the future development of Somalia. At the same time the people of Somalia must hold their leaders accountable, putting personal or clan differences aside. Ultimately understanding the process, challenges and time required with oil exploration may help answer the question if the stories of every rock underfoot covering a gem stone or a pool of oil were true. The first Somalia oil well was drilled by Sinclair Oil Corporation in 1945 with approximately 70 wells drilled to date without recoverable amounts of hydrocarbons discovered.

There has been very limited exploration activity since the civil war began and companies declared force majeure, but unless the people of Somalia come together as a nation to attract investment for oil and gas exploration activities, it is unlikely the question will be answered in the immediate future.