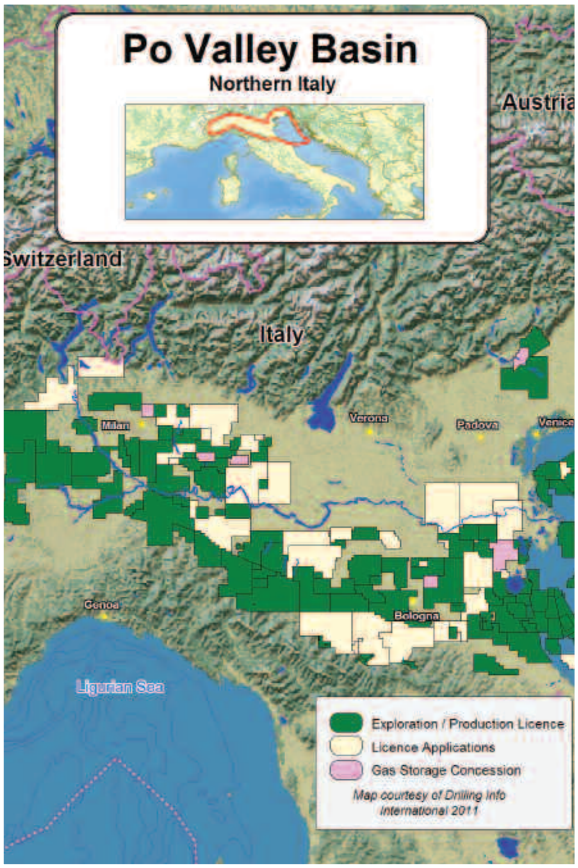
An Overview of the Regulatory Framework, Fiscal System, and Marketing of Oil and Gas in Italy



Italy is one of the most attractive oil and gas fiscal regimes within its peer group of countries. When considering key performance indicators such as government take, full cycle rate of return, profit to investment ratio, and exploration cover ratio, Italy's fiscal regime is highly ranked. Italy is the fourth most populated European country and the third largest European gas market after the UK and Germany.

Highly dependent on foreign energy sources, Italy has some of the highest energy prices in the world. What's more, emissions management, energy security, and new found concern regarding the dependence on and reliability of Russian and North African imports are putting a premium on commercial gas reserves within Europe. High energy prices along with Italy being a highly urbanized country with a developed infrastructure and extensive national grid have resulted in attractive development economics. Consequently, reserves do not have to be large and geographically concentrated in order to be commercially viable.

ITALIAN UPSTREAM OIL AND GAS REGULATIONS AND LICENSING PROCESS

We note that principle terms and regulations may vary slightly in onshore Sicily compared to the rest of Italy as Sicily has its own regulations.

Exploration License Application Process

The first time a company applies for licenses or farms into existing licenses, they must submit documentation to the Ministry of Economic Development (MOED) showing technical and financial capability. MOED may ask for a bank guarantee.

On lodging an application with MOED, an announcement is published in the official bulletin of hydrocarbons (BUIG) which subsequently opens a 3-month competition period where other parties may lodge an application covering the same area. Upon reviewing applications to license, a technical committee of MOED may:

1. Approve an award to a party that has lodged an application
2. Propose a joint venture be formed
3. Decline all applications

Preliminary granting of licenses is subject to approval of an Environmental Impact Assessment (EIA) report. If the license contains protected areas, a more detailed environmental study may be required as opposed to the standard screening process. Onshore, the EIA procedure is handled by the regional governments with processes that may differ slightly region-to-region ranging from closed meetings among local authorities to open meetings with local communities. For offshore licenses, the EIA report authorization is obtained from the Ministry of Environment. In any case, the public is always informed about any EIA process. Upon approval of the EIA report, the final granting of the license is made by MOED.

Exploration Licenses

Exploration licenses are issued for a six-year term, with the option to extend for two additional 3-year terms subject to the fulfillment of the approved work program. One well is the minimum required commitment in the 3 periods (6 years + 3 + 3).

Work programs are subject to a penalty for failure to perform equal to 10 percent of the program investment, not to exceed €140,000. Deferrals to programs resulting from delays in parallel government approvals and events beyond the control of the licensee are acceptable provided proper notification is made to the relevant authorities in a timely manner.

The government accepts the commencement of civil works as the start

Map courtesy of Drilling Info International, 2011

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of drilling operations. This is typically the construction of a drilling pad, which is a more substantial concrete platform than is typical of the global industry.

As an incentive the government offers up to a 40 percent refund of costs incurred for the acquisition of new seismic subject to submittal of documentation. The refund, if approved, is made in the year following the submittal of documentation.

Production License Application Process

When a discovery has been made, the operator has the exclusive right to proceed toward development. As a consequence, the production license approval process differs from the exploration license approval process because it is not exclusive. The remainder of the process includes preliminary granting, EIA report approval, and final granting. The application process may take more than a year. MOED approves the work program considering both technical and economic issues. Oil and gas resources are considered state property.

Production Licenses

Production licenses are issued for 20 years, with a 10-year extension granted upon demonstration of continued commerciality and full respect of the approved work program. MOED and the Ministry of Environment have full oversight regarding operations, health and safety, and environmental protection. Both Ministries have the right to stop any activity when warranted.

ITALIAN FISCAL SYSTEM

The fiscal system in Italy is based on a royalty and tax model.

Royalty

Royalty rates vary depending on product type and location, onshore or offshore. The exception to this is Sicily, where royalties are fixed at 10 percent for both oil and gas independent of the concession location (i.e. onshore or offshore).

	Oil (percent)	Gas (percent)
Onshore	10	10
Offshore	4	7

Royalty exemptions also vary depending on product type and whether production is onshore or offshore, again with the exception of Sicily.

	Oil (10^3 tonnes)	Gas (10^6 cubic meters)
Onshore	20	25
Offshore	50	80

These exemptions are quoted per field and per year. Around 30 percent of domestic gas production and around 7 percent of domestic oil production are ultimately exempt from royalty.

For more information regarding oil and gas royalties in Italy, refer to the Directorial Decree dated 22 March 2011 published in BUIG LV No.3 dated 31 March 2011.

Surface Fee

An annual surface fee is due with the amount ranging from €6.82 per sq km during the first period of an exploration license to €81.71 per sq km during the extension of a production license.

VAT

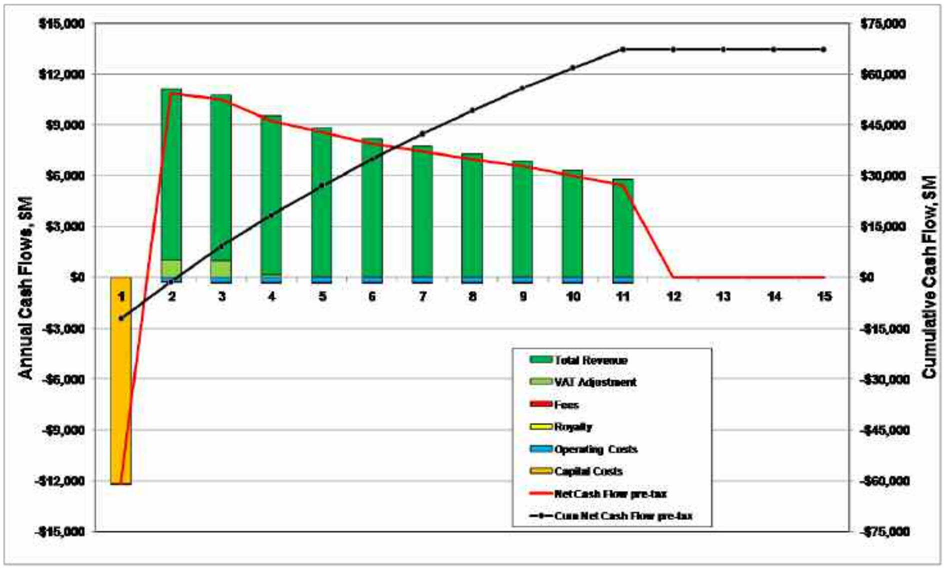
Value added tax (VAT) is charged at a rate of 20 percent on all expenditures associated with exploration and development activities. VAT is collected on all oil and gas sales at a rate of 20 percent. If oil and gas is sold to industrial or non-end users, the VAT rate is reduced to 10 percent. Given the nature of the business, E&P companies will generally accumulate a VAT receivable in the first few years of operation. VAT receivables may be carried forward each year without time constraints and, in addition to VAT payables, may be used to offset various taxes (e.g. corporate income tax, certain regional taxes, etc.) and employee welfare obligations up to €516,457 per annum.

Corporate Income Tax

Corporate income is taxed at a rate of 27.5 percent (IRES) for oil and gas companies with turnover of €25 million or less. If an oil and gas company's turnover exceeds €25 million, an additional "Robin Hood" tax is applied at the current rate of 6.5 percent. On 13 August 2011, the Italian government proposed an increase in the "Robin Hood" tax on energy producers from 6.5 to 10.5 percent for a three-year period along with proposing to extend the tax to include energy transmission companies. The plan will need the approval of the Italian Parliament before coming into effect.

A regional income tax (IRAP) of 3.9 percent is levied in addition to IRES unless the company's headquarters are located in the Lazio or Sicily regions; in which case the current tax rate is 4.8176 percent. In November 2008, the government approved a decree that would allow 10 percent of IRAP to be deductible for IRES purposes.

Fiscal allowances on depreciation for intangible and tangible assets vary by asset type. As a general rule, fiscal depreciation



Pre-Tax Cash Flows: 5 BCF Gas Development, Onshore Po Valley Basin, Italy

Size (BCF)	5.00
Gas Price ($/MCF)	15.40
Capex ($/MCF)	2.44
Opex ($/MCF)	0.58
Value ($/MCF)	7.19
NPV 10% (MM$)	35.97

on tangible assets is applied on a straight-line basis (as opposed to a unit-of-production basis) over the economic useful life of the asset. The Ministry of Finance provides guidance on depreciation rates. On average the annual depreciation limit is 25 percent.

MARKETING OF OIL AND GAS IN ITALY

Background

For 50 years, from 1953 to 1997 until market liberalization began in 1998, oil and gas activities in the Po Valley region of Northern Italy were monopolized by the state-owned oil company ENI-AGIP. The liberalization process has gone through various phases resulting in inter alia the break-up of ENI's monopoly. In 2000, the Letta Decree enabled legislation to introduce competition in gas supply, to allow third-party access, and to require the unbundling of SNAM, local utilities, and market share restrictions on ENI.

The Po Valley region is a prolific gas producing province with over 30 TCF produced since production commenced in the early 1950s.

With a consumer base of 60 million, an annual domestic production of around 7 billion cubic meters of gas, and an annual demand of around 80 billion cubic meters, Italy imports roughly 90 percent of its annual gas requirements.

According to the latest official data (Ministry of Economic Development, Department for Energy, 2010 Annual Report), reserves are considerable: more than 150 billion cubic meters of gas (2P unrisked) and approximately 2.5 billion barrels of oil (2P unrisked), making Italy attractive for exploration activities. Italy's strategic geographic position makes it a natural hub for supplies to Europe from Africa, the Middle East, and the Caspian Sea. Import pipeline and infrastructure construction was a primary focus for ENI and its affiliate SNAM in the 1970s and early 80s enabling it to gain strategic ownership of those assets. At present, Italy has a diversified supply portfolio procuring from the North Sea, Russia, Algeria, and Libya. Most of the capacity is covered by Take or Pay contracts. This market dynamic plays an import role on domestic gas prices and the structure of gas supply contracts.

Market Structure and Gas Pricing

Major downstream market sectors include industry, power generation, and commercial and residential use. Generally, gas in Italy is sold through long-term oil-indexed contracts with pricing based on ENI Gas Release formulas; although fixed prices and the spot market are becoming more popular within the industrial sector. The residential market is open to competition but prices are regulated.

ENI Gas Release formulas, which ENI updates periodically, are driven by diesel, fuel, and crude oil prices. The formulae are generally calculated monthly based on a multi-month backward rolling average. It is noteworthy to mention that despite the various tariffs, calculation changes, and other updates, the difference between ENI Gas Release formulas are generally minimal and a smoothing mechanism is always included (e.g. multi-month backward-rolling average). As of mid-year 2011, wellhead gas prices for the onshore Po Valley Basin region of Italy have been approximately $15 per MMBTU.

In Italy the gas supply chain has been completely deregulated therefore domestic producers may sell gas directly to end users. The capital and structural requirements (including a certain capacity of storage) for vertically integrated suppliers create a natural barrier to entry. Gas sale contracts for domestic producers have a term of 3 to 5 years on average and are normally organized through a public tender.

Europe is becoming a more integrated market. Declining North Sea gas production and the temporary roadblocks to shale gas development (France) has had a strong ripple effect on the Italian and European markets. Germany's recent decision to phase out nuclear energy will have a major impact on European energy procurement. European governments may favor gas over alternative energy sources because of its availability from multiple sources at competitive prices and its lower carbon emissions. The great paradox of Italy is that although the regulatory process creates time-to-market issues, market deregulation at the national and European level and attractive profit margins have significantly increased the number of very attractive commercial opportunities in the Italian energy market.