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North Sea decommissioning: Primed for a boom?

Opportunities are ripe for a new wave of M&A transactions in the oil & gas sector

North Sea decommissioning: Primed for a boom?

The complexities and challenges associated with decommissioning offshore oil and gas assets have dampened M&A activity in the past—but change is coming, suggest **David Baker, Tom Bartlett, Richard Jones** and **Paul Griffin** of global law firm White & Case.

Historically, the attitude towards decommissioning disused offshore oil and gas platforms—'abandonment' as it was previously known—has been largely negative, with companies viewing mature installations as a burden rather than an opportunity for a new source of revenue. But the mood has changed.

Following the sharp drop in oil prices in 2014, incumbent owners, keen to repair their balance sheets, started to view their ageing assets as an opportunity to pass on these operations to smaller, more nimble players whose business is better suited to carrying out smaller works, and who are likely to enhance overall recoveries.

With an estimated 20 billion barrels of oil remaining in the UK Continental Shelf (UKCS) and prices starting to stabilise at a level at which both buyers and sellers are willing to transact, deal activity in the UK North Sea is seeing something of a revival. According to the UK Oil and Gas Authority (OGA), 680 to 690 million barrels of oil are expected to come on stream from approved projects in 2017 alone. There are also many fully functioning late-life assets that, in the right hands, should continue to be operational for years to come.

The UK Government, which has ultimate responsibility for decommissioning on the UKCS, is actively encouraging new investment. However, investors need to get comfortable with a legislative regime developed by the UK Government that assigns liability to parties deriving financial benefit from petroleum assets—whether presently or in the past. The costs are broadly intended to fall on companies that hold licences for such assets, those who own the facilities, and those who operate them and benefit from the exploitation of related petroleum.

£3.6bn
Oil and gas deal value, UK North Sea since January 2017
Source: Mergermarket

Right price, right team

The allocation of decommissioning liabilities has always been a difficult issue in M&A deals, as sellers have traditionally sought a 'clean break' from these liabilities, while buyers have had to factor in the costs of decommissioning security and be comfortable with the fact that they can be liable even once they have sold on the asset. However, the boom times of high oil prices meant that deals were still getting done. Once the oil price dropped significantly, there was a period where very few deals happened, as concerns about decommissioning were coupled with a difficult pricing environment. While US$30 a barrel created potential upside for buyers, sellers were not willing to engage at that level. Now that the price appears to be stabilising at around US$50 (at time of writing), there is still potential profit for buyers while giving sellers comfort that they are getting meaningful value for their assets.

This stability is prompting interest among producers, and the supply chain and service sector, where new business models and innovative deal structures thrive on the opportunity of decommissioning.

There is also a growing appetite among infrastructure investors for pipelines and processing plants, such as CATS, FUKA, SIRGES and SAGE, which have been acquired by infrastructure or private equity

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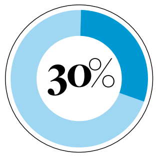
investors for their stable long-term revenue streams.

The mix of independents and smaller, private equity-backed companies now active in oil and gas facilities is boosting interest in the North Sea. Larger private equity players may bring capital, but they are keen to ensure that they are backing the right teams.

Mitigating the risk

Given the nature and scale of the assets involved, it is critical to have effective management and operations. Many sponsors identify a management team before they look to acquire an asset. Examples of this approach include CVC Capital Partners and Carlyle, backing former Centrica boss Sam Laidlaw to establish the Neptune platform; Blackstone and BlueWater, backing a senior team, again from Centrica, to form Siccar Point; and EIG, backing the Chrysaor team led by Phil Kirk to agree to acquire Shell’s North Sea assets. They are keen to find management teams that know how to operate mature assets profitably. The recent increase in North Sea M&A activity has encouraged other investors to follow suit, but decommissioning remains a big issue under the UK regulatory regime; previous interest holders can be liable for any default by current or future interest holders if there is a shortfall in security. Residual liability is a particular concern for private equity players, as there is some risk that the liabilities may extend to the fund itself, not just the special-purpose vehicle established to acquire the asset. Finding deal structures that reassure private equity investors and help them mitigate the risk of exposure to decommissioning liabilities may hold the key to greater activity.

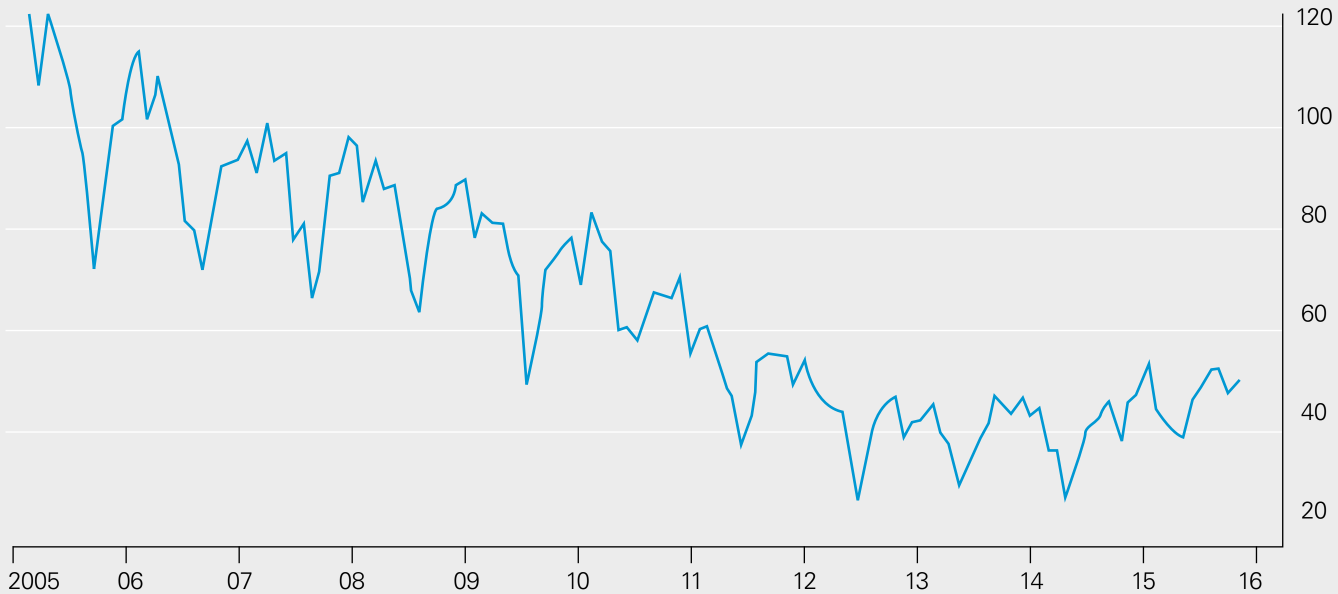


Decrease in average unit operating costs from 2014 to 2016
Source: UK OGA

More recently, there has been a focus on facilitating the use of specific Decommissioning Security Arrangements—DSAs. The broad purpose of a DSA is to create, during a field’s operations, a fund sufficient to meet the expected decommissioning liabilities after cessation of production.

UK Continental Shelf oil and gas production

Million barrels of oil equivalent per month



Source: Oil & Gas UK

The joint venture (JV) partners responsible for oil and gas facilities will typically make periodic contributions towards a fund to ensure that sufficient money is available when the use of those facilities ceases to meet the costs of decommissioning. The value of the fund is based on the operator's estimates of decommissioning costs multiplied by a risk factor. The amount and form of security for the ultimate costs of decommissioning is subject to periodic recalculation. Under traditional deal structures, a DSA should help to ensure that a seller receives a 'clean break' from any decommissioning liabilities.

Liability-sharing mechanisms

The liability in respect of the eventual costs of decommissioning is an important aspect of any M&A transaction in the sector. New entrants and incumbents are increasingly looking for effective—and indeed novel—ways to apportion decommissioning liability.

Recent transactions—BP's sale of Magnus to EnQuest (see below and opposite) and Shell's sale of its North Sea portfolio to Chrysaor—show a number of innovative approaches to dealing with decommissioning liabilities outside of traditional DSAs. They tend to focus on the retention of decommissioning liability by the sellers, either by agreeing to remain financially liable or by utilising their enhanced expertise to carry out the decommissioning itself. As more deals are crafted and precedents are set, realistic calculations of eventual decommissioning costs will become easier. Although each asset will continue to be unique from a technical due diligence perspective, the increase in the available information should create the foundations for more effective negotiations between the majors that are prepared to retain such liabilities for strategic reasons and smaller players whose balance sheets cannot readily absorb huge decommissioning costs.

A good example of a contract with retained liability is BP's sale of its stake in the Erskine oil field to Serica Energy. Among the terms of the agreement was BP's acquisition of a 5 per cent shareholding in Serica Energy and a partial retention by BP of the field's decommissioning liabilities. The agreement holds BP responsible for any decommissioning liabilities up to an agreed maximum, with Serica Energy liable for any excess above that amount.

Several factors are combining to make late-life assets attractive to new investors. These include tax incentives, insurance products, specialist operating companies, deferred dismantling and advanced technology. These factors may lead to significant savings for major oil and gas companies while offering plenty of opportunity to the savvy independent or investor in the meantime.

Groundbreaking agreement

In January 2017, EnQuest finalised its intricate deal to take on an initial 25 per cent interest in BP's Magnus oil field. EnQuest management avoided the upfront payment of US$85 million and instead funded the deal from future cash flow from the project. The late-life operator also has the option to purchase the remaining 75 per cent stake in the field for a further US$300 million in 2018 (of which a third would need to be paid upfront).

The company was careful to cap its exposure to decommissioning at the amount of positive cash flow that it will achieve from the asset. Of course, this was only possible due to the alignment with BP's wish to retain certain tax relief exposure.

> "New business models and innovative deal structures thrive on the opportunity of decommissioning

30 years

Expected timeframe for decommissioning all UK North Sea assets

Source: UK OGA

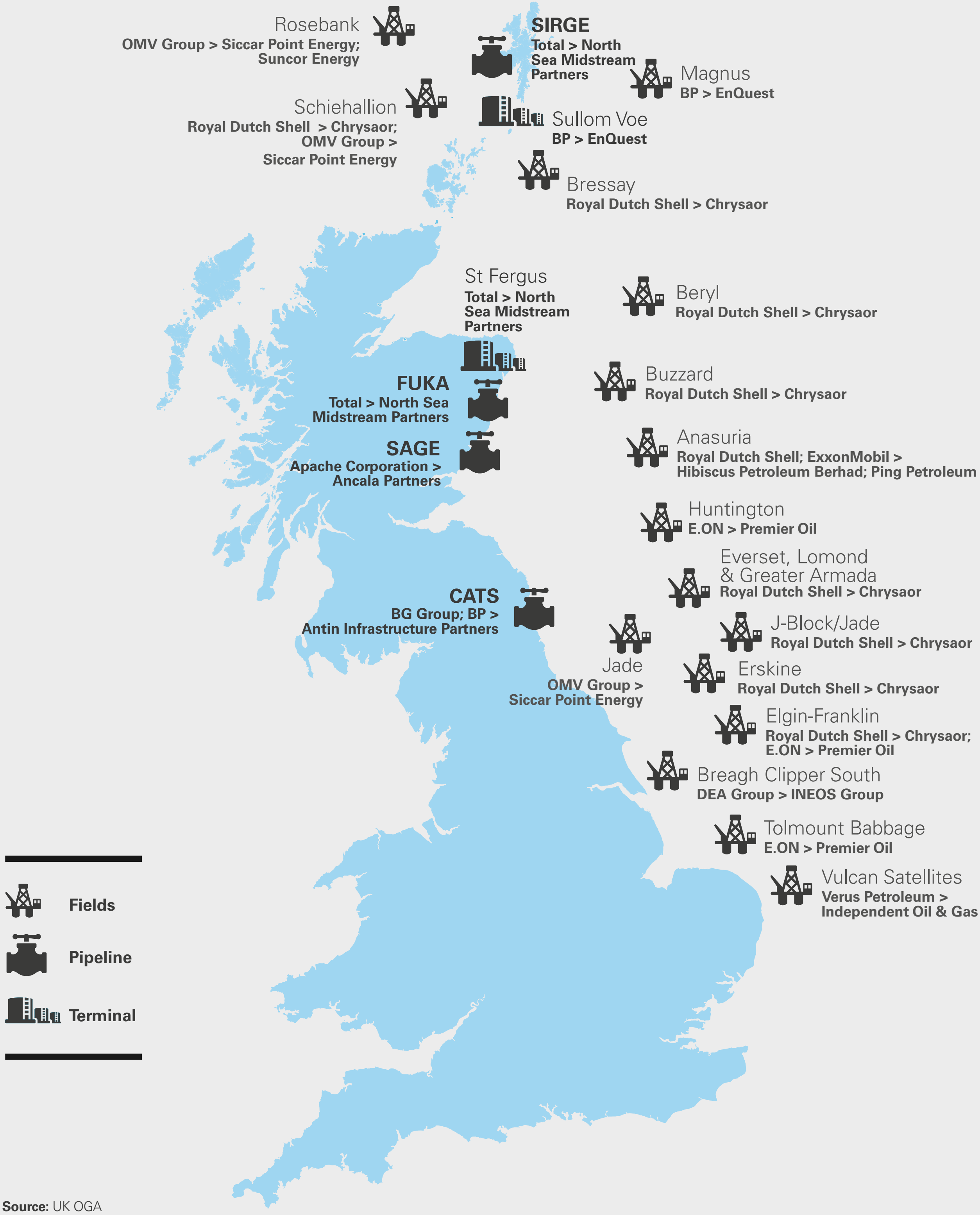
Growth prospects

Decommissioning costs are set to decline, as more specialist contractors enter this market with advanced technology and compete for contracts. Oilfield services companies are already investing in top-of-the-line equipment to cater to these projects, with Heerema Marine Contractors serving as a prime example. This new equipment is important not only from a cost perspective but also for project timelines, as there are only a few vessels equipped to handle such heavy lift work.

The UK North Sea will see significant change in the coming years as the decommissioning market develops, not just in terms of technologies and players, but also with regard to insight about costs and risk. Increased collaboration is likely to lead to standardisation of costs and create a knowledge pool that will lower the barrier of entry for new players and make complex projects more manageable. Meanwhile, the insurance market will continue to widen its products base in response to demand, and the advent of fixed-price decommissioning may well set a precedent for contract standardisation.

All of these developments point to more favourable conditions and growth opportunities for the market and the further removal of what has historically been one of the main barriers to North Sea M&A.

Examples of assets changing hands



Source: UK OGA

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