WHITE & CASE

Oil & Gas Series 2017

The opportunity and promise of decommissioning

Wednesday, 3 May 2017

David Baker, Tom Bartlett, Paul Griffin and Richard Jones

Introduction

The UK's oil and gas decommissioning regime has long been seen to be in the front-line of petroleum developments and operations around the world, and much has been said about the resulting decommissioning liabilities and their management over time. However, recent steps towards the government's overall aim of maximising economic recoveries and the arrival of funds and private equity investors into the ownership of oil and gas facilities have meant that some now see opportunity in these liabilities. At the same time, a number of the incumbent owners of late-life facilities appear to be re-appraising their traditional resistance to any retention of liabilities upon the transfer of those facilities. Recent deals and developments show a testing of the established commercial and liability arrangements.

Whether they are seen as a threat or an opportunity, it is timely to re-consider these existing arrangements. These matters are relevant not only to those with interests in the UK, but also to those engaged in the oil and gas business around the world.

Responsibility for decommissioning

The UK's legislative regime is based on its rights and liabilities under the applicable international treaties. These include the UN Convention on the Law of the Sea 1982 (UNCLOS), the Convention for the Protection of the Marine Environment of the North East Atlantic 1992 (OSPAR) and the Convention on the Prevention of Marine Pollution by Dumping of Wastes and Other Matter 1972.

That legislative regime is represented by the Petroleum Act 1998 and the Energy Acts of 2004 and 2008, as well as their associated regulations. This regime is administered by the Department of Business and Industrial Strategy, through the Oil and Gas Authority. In administering this regime, the UK Government seeks to explore options for the re-use of facilities, to execute decommissioning in the most cost-effective way and to balance these aims with the maximisation of value from economically recoverable resources.

The UK Government also looks to ensure that the costs of decommissioning petroleum facilities will not fall on it, but on those deriving economic benefit from those facilities. Broadly these costs are intended to fall on those who own those facilities, those who manage them and those who benefit from the exploitation of related petroleum. This community is a broad one and is capable of extension to previous owners and associated entities. The UK Government has committed to a reasonable and proportionate approach in considering where these liabilities will come to rest among a number of companies potentially liable. However some might say that past practice has suggested a broad ambivalence as to who is to pay, provided that the UK Government can reliably call on somebody to pay.

Process and costs of decommissioning

Section 29 of the Petroleum Act 1998 provides for the Secretary of State to serve notice on any of those persons, requiring them to submit a decommissioning programme setting out matters such as the estimated costs and timing of decommissioning operations. The practice is for service of a decommissioning notice at the start of commercial operations, with submission of a decommissioning programme by (usually through the operator for) the relevant entities at a later date, to be notified.

This later date will ordinarily be determined by the UK Government by reference to the standing of the relevant companies, the estimated revenues from petroleum production and the estimated costs of petroleum operations over time. These assessments require expertise and quite some clairvoyance. They are necessarily replete with uncertainty, not least in respect of future petroleum prices and the duration of continued production. In practice, such notices will be served by the UK Government in good time before decommissioning may be required. Once the decommissioning programme is submitted and agreed, the obligations to carry out that programme are joint and several among all those served. There are guidelines as to which of those responsible (or potentially responsible) might be called forward by the UK Government in the particular circumstances.

The costs to be associated with the required decommissioning operations may be little easier to assess over time. For example, the extent of physical removal required under the UK's regulatory regime is a matter of current debate. The established approach has been for complete removal to reinstate a clean sea-bed, although there have been exceptions. Quite recently, discussions have turned towards the potential advantages of leaving certain sub-sea installations, particularly concrete ones, on the grounds of marine and environmental benefits. The shadow of the Brent Spar remains though.

Uncertainty also exists in relation to taxation and fiscal considerations, and the scope for perpetual liabilities under the decommissioning regime. As thoughts turn to corporate and covenant strength and financial and payment security for the carrying out of decommissioning operations, the creation and administration of trust funds or money pools become matters of high importance.

Transaction practice and contractual arrangements

The traditional approach in North Sea M&A deals has been for the seller to seek a clean break from decommissioning liabilities and, in the absence of specific release, to require from the buyer an indemnity with related financial security. Until recently, the seller's retention of those liabilities has been a rarity, save perhaps in relation to the "reverse payment" deals of the early 2000s where a payment by the seller of assets was intended to cover these future liabilities. Where this liability has been retained, that retention has tended to be limited and the customary arrangements for financial security have applied, albeit adapted to the circumstances.

Arrangements for decommissioning liabilities among field participants have tended to be included in joint operating agreements and it has not been unknown for these arrangements to be inconsistent with those of sale and purchase agreements, in some cases resulting in demands for more than abundant security. The practice more recently has been to implement specific decommissioning security arrangements (or DSAs), often by reference to a model form DSA developed by Oil & Gas UK. The broad purpose of these arrangements is to create during a field's operations an available fund (by means of guarantees, letters of credit or cash held in trust) sufficient to meet the expected decommissioning liabilities.

While there is a standard form of DSA, the circumstances of each field and its participants will be far from standard. For example, valuable tax reliefs may be available in respect of decommissioning costs. The continued availability of those reliefs has been assured by the UK Government under the terms of decommissioning relief deeds (or DRDs). This assurance has led to "post-tax" DSAs where the provision of security may be reduced and delayed to take into account future tax reliefs, dependent in each case on the circumstances of the participants and the nature of the assets to which the liabilities attach.

The timing, nature and extent of the security to be provided from time to time will be assessed by reference to the prevailing circumstances, including the estimated remaining value of petroleum and estimated decommissioning costs, as subjected to appropriate risk factors. This assessment will usually be carried out by the field operator, and on an annual basis.

Initiatives and developments

Recent transactions demonstrate a number of innovative approaches to dealing with decommissioning liabilities, while maximising recoveries and enhancing overall values. These show a tendency to marry the ambitions of late-life, low-cost operators to enhance production and extend field life (without adopting decommissioning liabilities from past times) and the wishes of legacy owners to transfer moribund facilities and decommissioning liabilities which are certain, but of uncertain value and timing. The simple deferral of liabilities may be a material benefit for an existing owner; the potential implementation of lower cost decommissioning operations a hope if not an expectation.

Some sellers of late-life assets appear to have recognised that the avoidance or effective transfer of decommissioning liabilities is now unlikely. Each new deal seems to suggest that sellers and buyers of North Sea facilities are becoming increasingly sophisticated in assessing and allocating commercial values and decommissioning liabilities over time. In some cases this has involved an allocation of liabilities, with some transferring and some being retained. In others there has been a concentration on the role of the operator and the transfer and re-transfer of facilities. The preferred deal structure in each case is likely to have much to do with fiscal arrangements, and the availability and use of tax advantages. This is one of the ways in which the UK Government can make a material contribution to the alignment of interests of disposing, legacy owners and acquiring, late-life operators. Current consultations in respect of tax capacity, the repayment of earlier payments and the carrying back of costs are examples here.

To differing degrees, recent deals exhibit an appreciation for the potential separation of the facilities themselves and the liabilities that attach to them, and the varying retention or transfer of each. There are indications that companies are seeing decommissioning as a positive, strategic matter and one which can offer opportunities. Also, there are examples of sellers and buyers working together over the longer term to maximise the economic life of facilities. Perhaps it is no longer the case that those on the decommissioning train are fated to remain on board together, fighting for occupation of the rearward coaches as those facilities run inevitably towards the buffers. The following are examples of some recent deals and the principles adopted by the parties.

- **Premier Oil's acquisition of Eon's North Sea assets**

  In January 2016, Premier Oil announced that it would buy E.ON's UK North Sea oil and gas assets for US$120 million. As part of those arrangements, the parties identified certain decommissioning liabilities which were expected to be incurred and agreed an allocation of those costs to the effect that E.ON would retain up to fifty per cent of them, notwithstanding the sale of its interest to Premier Oil.

- **Serica Energy's acquisition of BP's interest in the Erskine field**

  Serica Energy bought BP's stake in the Erskine oil field in June 2015. Among the terms of the agreement was BP's acquisition of a 5 percent shareholding in Serica Energy and a partial retention by BP of the field's decommissioning liabilities. The arrangements provided for BP to be responsible for these liabilities up to an agreed maximum, with Serica Energy being responsible for any excess above that agreed maximum.

- **Enquest's purchase of Magnus field and Sullum Voe terminal interests**

  EnQuest announced in January 2017 its acquisition from BP of initial interests in the Magnus field and related facilities including pipeline and terminal facilities, with BP agreeing to retain decommissioning liabilities. This general principle of retention of liabilities is subject to further arrangements concerning subsequent payments in the light of actual events and alternative arrangements for physical operations and the carrying out of decommissioning works.

- **Chrysaor's acquisition of Shell's Buzzard, Beryl and other interests**

  In early 2017, Chrysaor agreed to acquire Shell interests in some nine petroleum fields. The transaction was notable for a number of reasons, including the presence with Chrysaor of US investment fund EIG and a transaction value of more than US$3 billion. Also notable was Shell's retention of a material proportion of the eventual decommissioning costs of these interests.

And while recent attention has tended to focus on the transfer of production and operating interests and liabilities, there have also been initiatives in the supply chain and the service sector. A number of companies are looking to specialise in decommissioning activities and to create specific facilities (particularly lifting facilities) and techniques (in relation to well-plugging for example) so as to standardise operations and reduce costs. It may be that decommissioning's Cinderella days are coming to an end as recognition of its significance grows and operators move towards specialisation, whether within field ownership or as outsourced providers of bespoke services. There are signs that the long-perceived "capability gap" for providers of dedicated decommissioning services may be narrowing.

The pursuit of new business models by some has been accompanied by the development of new products by others. In recent times, policies of insurance have been available to those looking to manage their risks of being pulled into the circle of those to whom decommissioning liabilities attach. Now, policies of broader application are being developed.

Decommissioning disputes

In order to achieve the UK Government's priority of ensuring that the costs of decommissioning are borne by licencees and other private participants, once a section 29 notice has been served, all participants are jointly and severally liable for the decommissioning costs of the installation to which the notice pertains. This inevitably puts the onus on those participants to determine between themselves how the costs should be allocated. The potential for disputes is significant and is, at least, commensurate with the uncertainty that surrounds the potential for liability.

In large part, disputes are likely to revolve around DSAs and the adequacy of the security provided. Such disputes would be between the participants themselves and would concern issues such as the calculation of net costs (i.e., the best estimated costs of performing all decommissioning) and net value (i.e., the expected revenues from a field's production). These disputes would be resolved by expert determination. However, it is also likely that disputes could arise between the participants on the one hand and the Secretary of State on the other. Such disputes would most likely concern the effectiveness or withdrawal of Section 29 notices, and the decommissioning programmes themselves, and would have to be resolved by the courts rather than an expert. In any event, given the scope for disagreement as to the amount of security that is required and the uncertainty surrounding the variables used in calculating the same, all of the dispute resolution procedures used in relation to decommissioning disputes are likely to be put to the test.

Summary

In some jurisdictions, such as the UK, the laws and regulations of decommissioning were developed long ago and may not now be the most appropriate means of achieving the intended protection of the environment and of the tax-payer. In other jurisdictions, and particularly those with production sharing regimes, little regard may have been had at the time of making those agreements to the then far-off days of the ending of hydrocarbon production, which had not then yet even begun.

Whatever the prevailing treaty, legal, regulatory or contractual arrangements, questions will arise in relation to their suitability for establishing the nature and optimal extent of removal of facilities and restitution of the environment, and how the long-term responsibility for decommissioning of oil and gas facilities is to be organised among governments, citizens, oil companies and others.

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