Investment in Oil and Gas Midstream Infrastructure

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At a time of uncertainty for the long-term prospects of oil prices, midstream infrastructure divestments in the North Sea could help oil and gas companies maintain the viability of UKCS oil and gas production.

The North Sea's midstream sector is currently enjoying increasing interest from specialist infrastructure funds, pension funds and private equity firms ('financial investors'). Midstream operators typically charge fees under long-term contracts for the use of their gathering hubs, riser platforms, pipelines and onshore terminals. Financial investors are therefore drawn by the prospect of predictable returns that a tariff-based business model offers.

For many exploration and production (E&P) owners, who previously enjoyed the benefits of midstream infrastructure ownership when the industry was thriving, this surge in activity has presented opportunities to dispose of non-key assets, focus capital on upstream activities and raise much needed cash. Sinking commodity prices have left many oil and gas companies, particularly those with significant debt loads, in search of new sources of capital.

Current Market

While the UK midstream asset market has not historically been seen as particularly liquid, a number of recent deals suggest that the sector will follow established trends in North America, Norway and the Netherlands, where midstream assets have changed hands much more regularly. In March 2016, North Sea Midstream Partners (NSMP), an affiliate of US private equity investor ArcLight Capital Partners, completed its acquisition of Total's 100% interests in both the Frigg UK pipeline and St Fergus gas terminal as well as a 67% interest in the Shetland Island Regional Gas Export System pipeline. This followed NSMP's 2012 acquisition of the Teesside Gas Processing Plant.

French private equity firm Antin Infrastructure Partners has also been an active player in the sector, acquiring from BG in 2014 a 63% stake in the Central Area Transmission System (CATS) and then acquiring BP's 36% operated interest in CATS in 2015. CATS consists of a fixed-riser platform, subsea pipeline, and onshore gas processing terminal at Teesside.

Further North Sea divestments are now expected: BP is considering the sale of the Forties Pipeline System, which is ten times larger than the CATS and includes the Kinneil Terminal oil and gas processing plants, and US energy group Apache Corporation has been looking to sell its 30% stake in the Scottish Area Gas Evacuation system (SAGE), which comprises 323km of offshore gas pipelines running from the Beryl and Brae gas fields to the SAGE gas terminal at St Fergus. Shell is rumoured to be considering divesting some of its midstream infrastructure as part of its announced US$30bn disposal programme to fund its US$53bn acquisition of BG Group.

Wood Review

The interest in the UK midstream sector from financial investors has been welcomed by many – particularly supporters of the Wood Review – as a positive development towards securing the North Sea's future.

Commissioned by the UK Government in response to declining production and a rapid reduction in production efficiency in the UK Continental Shelf (UKCS), the Wood Review looked at ways of maximising the economic recovery of oil and gas from the North Sea. In setting out its "Infrastructure Strategy", the Review highlighted, among other things, the benefits of an open midstream network to facilitate access to infrastructure and allow the exploitation of marginal fields (which would otherwise be uneconomic) through the shared use of existing infrastructure.

Unlike E&P entities, who prefer to invest their capital in more profitable upstream activities, midstream specialists focus on managing and upgrading existing infrastructure and providing other support services to third parties. The disposal of midstream assets frees up capital for upstream operators who can focus on improving production efficiency from mature UKCS assets.

The Wood Review also recommended that the UK Government put in place a new commercially-focused regulator with broad powers to promote UKCS hydrocarbon recovery. This led to the establishment, in April 2015, of the Oil and Gas Authority (OGA). Amongst the recommendations included in the Wood Review was that the OGA should make full use of current legal powers to facilitate access to infrastructure, as well as take measures to facilitate the development of new infrastructure business models, either from new entrants or existing participants. This gives rise to the possibility that if existing UKCS operators do not open up to shared access, the OGA may force their hand.

Ownership Benefits

Backed by a more powerful regulator that wants to ensure infrastructure access is available to all, E&P companies are increasingly taking the view that midstream assets do not necessarily need to be owned by them to ensure a route to market for their hydrocarbons. Financial investors are attracted by the predictable and stable return that ownership of midstream assets can deliver, although the terms of the specific contracts for any asset will be crucial to an investor's assessment of value. A financial investor will look for a well-negotiated long-term transportation and/or processing agreement with upstream owners, including a robust tariff-based (and inflation-linked) structure and send-or-pay obligations on users, as a key element in achieving their desired return and reducing their exposure to commodity price fluctuations.

From the perspective of the UK Government and other UKCS participants, the potential for specialist owners to take on the management of existing infrastructure and subsequently invest in new infrastructure, such as gas gathering facilities to link up a number of fields, relieves the pressure on the increasing number of smaller players in the UKCS who may not individually have the means to invest in necessary infrastructure on a standalone basis.

Risk and Barriers to Entry

Of course there are risks to be faced when entering the midstream sector, both in terms of short-term transaction execution risks and also the longer-term success (or otherwise) of the investment.

Shorter-term risks

- The completion of a midstream transaction is invariably conditional on the consent of all the contractual counterparties, because either the transaction is structured as an asset deal or a hive-down or other form of restructuring is needed to implement a share deal. As financial investors are relatively rare in the North Sea, many contractual counterparties can be wary of them, particularly when the purchaser vehicle is a highly leveraged SPV. The strength of the relationship between the seller and the counterparty, together with the industry credibility and experience of the buyer, can be crucial in obtaining these consents.

- Financial investors will invariably lack the capability to actually operate and maintain midstream assets. Whilst the lack of technical expertise can be overcome through the employment of specialist contractors to carry out these activities (such as px for NSMP and Wood Group for Antin), the economics of the operating arrangement with the specialist contractor against the operating costs of the incumbent operator will be critical in determining whether midstream assets ownership can generate the desired returns. Sellers will also want to see that these contracting arrangements have been put in place in advance and that completion is not conditional on the investor entering into them.

- There can be complexity in unbundling assets which are integrated within an existing E&P business or are owned as joint property under an upstream joint venture arrangement. Sellers and buyers will need to consider how a pipeline can be disconnected from existing upstream infrastructure without compromising the route to market, given the integration of the UK's offshore pipeline and infrastructure network. Where a seller intends to retain access to infrastructure that it has previously used to transport equity hydrocarbons (meaning the seller will be a principal customer of the new owner), the negotiation of the underlying transportation agreements can add an unusual dynamic to the M&A process.

Longer-term risks

- Given prevailing oil price economics, counterparty risk will likely be a real concern. Even with long-term robust contracts in place, returns may not be achievable if underlying fields are not deemed viable or smaller scale E&P operators become insolvent, and transportation demand disappears.

- One of the biggest long term risks, and the one that perhaps hinders North Sea M&A more than any other, is decommissioning. The UKCS is a mature basin, and the UK offshore oil and gas industry is now plugging and abandoning more wells than are being drilled. Consequently, the focus of many North Sea participants is turning to the decommissioning of infrastructure, a task that has been accelerated by a persistently low oil price. Prospective UKCS entrants need to fully assess the inherent uncertainties and risks associated with decommissioning and understand the extensive powers of UK Government to impose liability on companies for decommissioning costs.

- Decommissioning obligations arise when the UK Government (through the OGA) serves a notice under section 29 of the Petroleum Act 1998 on licence interest holders and the operators and owners of any relevant installation or pipeline. The section 29 notice will set a deadline for a decommissioning programme to be submitted to the OGA; often this is a future date towards the end of the economic life of the field or installation. Once the decommissioning programme is approved by the OGA, all section 29 notice holders must comply with it and carry it out on a joint and several basis. This means one notice holder could be liable for the full costs of the decommissioning programme if the other notice holders are unable to meet their obligations.

- The UK Government can also serve a section 29 notice on a parent or associated company of a licence holder or owner of an installation or pipeline. Broadly speaking, a company is associated with another company if it directly or indirectly controls the other company or if a third party company controls both of them (and for a financial investor, it would likely include the general partner of the fund and its portfolio companies), and the UK Government could in theory impose decommissioning liability on a number of associated companies in a corporate group.

- The sale of a licence interest or an installation does not mean the seller's decommissioning liability will end. The UK Government can require a previous section 29 notice holder (or any person on whom a section 29 notice could have been served since the date of issue of the first notice, namely a current or former associated company of any current or former licence holder) to carry out the decommissioning programme with other section 29 notice holders. Regulatory guidance published by the UK Department for Energy and Climate Change (DECC) in 2011 describes this recall power as "a measure of last resort" that would be used in a default scenario. DECC has also stated that if recall action is taken, it would aim to agree a fair and reasonable distribution of the liabilities through discussions with all relevant notice holders.

- The industry has sought to mitigate the risk of former owners and their associated companies being made liable for decommissioning through the use of decommissioning security agreements (DSAs), under which field/installation participants are required to provide security against future decommissioning costs. The general principle of a DSA is that it uses a trust fund structure to hold the decommissioning security provided by each participant. If a participant fails to meet its decommissioning obligations, the other parties to the DSA or their associated companies (as beneficiaries under the trust) can access the defaulting participant's security to pay its share of the decommissioning costs. Acceptable security under a DSA usually comprises cash, letters of credit or a guarantee from a creditworthy parent or affiliate company. A financial investor will only likely be able to provide either cash or a letter of credit from an appropriate bank, with the corresponding impact on its financial returns. However, while a financial investor may feel it has a financial incentive to negotiate for the least expensive security mechanism in a DSA, ultimately its interests are aligned with the seller and the other owners in seeking to ensure there is sufficient security in the trust and therefore no residual decommissioning liability at the end of the asset's life.

Regulatory Considerations

Given ongoing developments in the UKCS regulatory framework, it remains to be seen how interventionist the OGA will be in implementing the infrastructure strategy contemplated by the *Wood Review*. Currently, midstream operations are not subject to the same degree of oversight as upstream operations but this could change in future. Perhaps the worst possible outcome for midstream financial investors would be a *Gassled* scenario occurring in the UK. In this case, investors (including Allianz Capital Partners, Canada Pension Plan Investment Board and Abu Dhabi's sovereign wealth fund) in the Norwegian *Gassled* network had to contend with a reduction of up to 90% being imposed on tariffs for transporting natural gas in the network when the Norwegian Government decided that cutting the tariffs would boost exploration and development for the local oil and gas industry at a time of low commodity prices.

There are differences in the UK operating environment that make this unlikely in the short term. For instance, returns from gas transportation infrastructure are regulated by the government in Norway, which is not the case in the UK. Nonetheless, if there is a proliferation of specialist small-scale independent infrastructure players, or there is concentration of ownership in the hands of a limited number of owners, the UK Government may well identify a need to control the market, or to use tariff regulation as a way to achieve the desired *Wood Review* objective on shared access to midstream infrastructure. Pressure on the UK Government to introduce legislation to regulate access rights and tariff rates may also come from upstream operators (particularly in a low oil price environment) seeking to benefit from lower tariffs to access independently owned midstream infrastructure.

Conclusion

As more upstream operators consider the disposal of midstream assets, it remains to be seen whether the development of an independent ownership model is an enduring trend that will continue to grow against a backdrop of declining production in the UKCS.

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