

## Introduction

The calculation of the amount of security that ought to be placed in trusts in anticipation of decommissioning is giving rise to significant disputes. The requirement to make these payments arises under decommissioning security agreements (DSAs). DSAs have evolved as a reaction to the fact that all co-licensees will be jointly and severally liable for any decommissioning costs, in order to provide mutual protection. DSAs provide co-licensees with a greater degree of security in the event of a decommissioning default. If a party to the DSA falls into financial difficulty, its security is called upon and the funds are held in a trust until the decommissioning is completed.

## How DSAs Operate

DSAs have facilitated the transfer of mature fields from established companies to smaller participants with fewer assets by avoiding duplication of security. Where an interest in a field or structure is sold, the seller will be concerned about its continuing joint and several liability to carry out decommissioning. For this reason, it is likely to require security from the purchaser. Oil & Gas UK has produced a standard-form DSA to capture industry practice, suggesting that co-venturers enter a DSA before submitting a development plan for the field. Security is usually given by letter of credit, or any other form agreed between the parties to the DSA.

The standard-form DSA requires that every year each co-venturer pays an amount equal to that party's share of "net cost" (multiplied by a risk factor) less its share of "net value", less the amount of any security that it may already have provided, into a trust, held until the end of the decommissioning process. Both net cost and net value are assessed on a net present value (NPV) basis. Where the NPV of the net cost exceeds the NPV of the net value, security is required to cover the difference.

The over-riding aim of a DSA is to ensure that guaranteed funds will be available to cover the decommissioning costs at all times. However, it remains to be seen whether this objective will be attained. Certain industry commentators are concerned that there has been a failure to adequately monitor amounts paid by participants under DSAs, leading to a historic under-provision in security.

## Disputes Over the Calculation of Net Cost

Net cost represents the best estimated cost of performing all decommissioning activities at the time at which they can be best estimated to need to be performed. There is significant scope for disputes.

## When Will Decommissioning Occur?

A core assumption input into the calculation of net cost is the expected date of decommissioning. The estimated date for decommissioning has a significant impact on the level of security to be provided. The hope that ageing infrastructure might find alternative use, as some structures (particularly pipelines) could be used via tiebacks and brownfield developments, seems challenging in the current low oil price environment. Other new technology, such as enhanced oil recovery (EOR) could also have postponed the date of decommissioning, but this is also only made economic by high oil prices. These possible ways to reduce the net cost, which could have been discounted back (through the NPV calculation) so as to reduce the amount of security required (and also to have postponed the trigger date for provision of security) are unlikely to be viable. This is significant, because these assumptions might legitimately have been included in previous calculations, made when the oil price was higher. Disputes are arising wherever these assumptions are being reversed out. Where optimistic assumptions have been made, inadequate security is likely to be provided.

## What Is the Scope of Decommissioning?

There are many different forms of installation. Most installations will require an individually tailored, and untested, method of decommissioning. Much current activity is underway in scoping out the proper decommissioning strategy. With so many variables the scope for disputes is considerable. Further scope exists for disputes over whether net costs should be based on a "left in place" basis for installations capable of attaining a derogation. Adopting this approach would reduce net cost. DECC guidance suggests it is likely to require the decommissioning costs for large concrete structures to be estimated on this basis. Derogations may, however, become less common due to advances in technology, and if this approach changes net cost may increase significantly. On the other hand, concerns about the carbon budget of extensive decommissioning operations, where every component is laboriously cut up and sorted onshore, may alternatively lead to more derogations being granted. It is easy to see how there is scope for disputes as to the most appropriate estimate to be used.

## What Is the Proper Risk Factor to Apply?

The Oil & Gas UK standard-form JOA provides for the use of a risk factor in the security calculation. This is to provide a degree of caution against possible rises in decommissioning costs. Net cost estimates will usually be prepared on a P50 basis. This assumes that there is an equal chance of there being under-spending or over-spending as against the costs estimate. The risk factor may not always have been calculated, or updated, in a fully statistically and rigorous manner. These uncertainties should reduce with time as the operator obtains a better understanding of these costs, and optional language in the DSA allows the contingency to be increased or reduced in a stepped process. Presently, the ease with which this variable can legitimately be changed is making it a target for attention and a prominent source of disputes.

## Disputes Over the Calculation of Net Value

Net value represents the best estimated production and other receipts from the field for so long as it is estimated that the field will remain in production. There is significant scope for disputes.

## What Oil and Gas Prices to Use?

Net value will be based on production receipts from the field. Fluctuating oil prices will have a significant impact on net value. Regular recalculations may lead to periodic changes in net value as oil and gas prices rise and fall. Assumptions as to future oil and gas prices should be clearly stated in the DSA. Published indices for oil and gas prices will need to be agreed. Essential to this calculation is the date on which production will cease. With so many variables, even slight adjustments can give rise to very significant variances between the parties. Since the introduction of decommissioning relief deeds (DRDs), net revenues and net costs are normally inputted on a post-tax basis (including royalties, corporation tax/supplemental charge, PRT) which have recently been changed and account will need to be taken of this. Net value does, however, take into account any tax relief or grants given or expected to be given unrelated to the costs of decommissioning. The operator is required to perform two calculations, one with and one without the effect of the relief.

## What Reserves Data Should Be Used?

Optional language under the standard-form DSA governs whether only reserves estimates approved by the Joint Operating Committee are to be used to calculate net value, whether the operator's best estimates, acting as a reasonable and prudent operator, are adequate, or other alternatives. Commonly, newer entrants into the UKCS will seek to maintain the level of reported reserves. There is concern that this may lead to the reserves estimate used in the calculation of net value being optimistic, which would result in the understatement of security. Without clear drafting, there is significant scope for disputes on these assumptions.

## How to Account for Tiebacks and Other Revenue?

Many fields receive significant revenues from tariff and other receipts from third parties, such as tiebacks. As these form revenue from the field, absent of express provision in the DSA to the contrary, they should be included. A dispute may emerge as to the degree of certainty required that these receipts will accrue. On one extreme, it is arguable these receipts should only be taken into account in situations where send-or-pay arrangements ensure that such tariff income is secured. On the other, such tariff income can be taken into account even though no agreement has been concluded, or where such agreement has been concluded but is of only a limited duration, so long as there is no other route to export for the tieback.

## Why Are These Disputes Arising?

Second-tier participants that sold their interest many years ago are liable to contribute to decommissioning costs if the first-tier participants default. Depressed production revenue due to falling oil and gas prices is causing second-tier participants (those benefitting from the security without paying in themselves) to seek higher levels of security, depending on whether the DSA gives them a right to approve the operator's proposals or merely comment on them.

DRDs also present a challenge for second-tier participants. The prior practice of calculating net costs on a pre-tax basis significantly increased the capital requirements that the first-tier participants were required to contribute to meet the security for decommissioning costs. With net costs now being calculated on a lower, post-tax, basis, less security is being provided, unless a higher risk factor has been applied to net costs. The move to a post-tax calculation of net costs highlights any historic under-provision of security.

Requests for additional security from second-tier participants are coming at a time where falling revenues and increasing costs are impacting on first-tier participants' ability to provide the greater levels of security sought. First-tier participants, incentivised to maximise cash flows, are likely, where possible, to have used lower risk factors, higher reserve estimates and other metrics to reduce the level of decommissioning security due under a DSA. This is particularly the case for those first-tier participants who are highly leveraged through reserves-based lending, and not all of the first-tier participants will have the same funding profile. They may legitimately take differing positions on the assumptions made by the operator.

For all of these reasons, this year's annual recalculation and review the security calculations is being carefully monitored by both co-venturers and by second-tier participants.

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