Decommissioning in the United Kingdom Continental Shelf: Decommissioning Security Disputes

Summary

This is the first year in which the full impact of the oil price decrease will have to be factored in to the annual decommissioning security process. This article focuses on the increasing concern across the offshore oil & gas industry as to whether the decrease in the oil price will result in insufficient security to cover escalating decommissioning liabilities. As a result of current market conditions, there has been an increase in requests for data, closer scrutiny of operator projections and a heightened risk of disputes about "net value" and "net costs", which are normally resolved through expert determination.

The Increasing Focus on Decommissioning

As set out in our initial publication titled "*Decommissioning in the United Kingdom Continental Shelf: Delay Disputes"* (see: http://www.squirepattonboggs.com/insights/publications/2015/10/decommissioning-in-the-united-kingdom-continental-shelf-delay-disputes), decommissioning activity is gaining increasing momentum in the UK.

The growth is clear both from the increased number of major decommissioning projects underway (including the Brent, Thames Area, Miller and Murchison Fields), and numerous decommissioning programmes under consideration (including the Viking Satellites, Harding STL and Leadon Fields). In fact, Oil & Gas UK's Decommissioning Insight 2015 states that, over the next decade, 79 platforms across the UK Continental Shelf are forecast for removal. This represents 17% of the approximately 470 installations that will require decommissioning over the next 30 to 40 years.

With revenue projections having fallen due to the oil price decrease and cessation of production (CoP) dates brought forward as a consequence (for example, the total forecast expenditure in the Central North Sea and the Northern North Sea/West of Shetland's region has increased by £3 billion with a total forecast for the industry of £16.9 billion over the 2015 to 2024 timeframe), previously healthy-looking security balances may now seem marginal.

Whether sufficient security has already been, or ought to now be, placed in trust is an area raising significant concern in the industry. It is likely to be a key focus in H1 2016, with the approach of the typical yearly deadline for decommissioning security estimates of 30 June. Against a backdrop of historic collaboration and practical co-operation, disputes about the level of decommissioning security have begun to arise.

Decommissioning Security Agreements (DSAs)

The primary requirements for decommissioning in UK waters are set out in the Petroleum Act 1998, as amended by the Energy Act 2008. Under Section 29 of the Petroleum Act, the Secretary of State may, by written notice, make a wide set of participants connected with or interested in a particular installation jointly and severally liable for all decommissioning costs of that installation.

To deal with this extensive and overlapping liability, the industry has developed DSAs, whereby each participant agrees to deposit cash or, normally, another type of security, such as letters of credit, into a trust. That trust operates to pay the costs of decommissioning when the time comes. If a party falls into financial difficulty, the security provided is intended to be sufficient to cover that party's share of decommissioning costs.

Parties to Decommissioning Security Agreements

Parties to a DSA include:

- First Tier Participants – this group will be composed of co-venturers under a JOA. Each member of this group will provide security for the upcoming decommissioning programme.
- Second Tier Participants – this group will be composed of those at risk of being caught by the extensive decommissioning regime. Such participants include oil & gas companies that sold their interest in the field, often many years ago. These participants remain parties to the DSA; one reason for this being to allow them to ensure that sufficient ongoing security is provided by the First Tier Participants.
- Third Tier Participants – these are not parties to the DSA, but can, by agreement, enforce the terms of the DSA using benefits derived under the Contracts (Rights of Third Parties Act) 1999.
- Secretary of State – if there is concern that those liable for decommissioning will be unable to discharge their decommissioning obligations; the Secretary of State may, for surveillance and enforcement reasons, become party to the DSA.

Impact of the Oil Price on Decommissioning Security

A field that was economically viable when the oil price was at US$100 per barrel may now, at the current oil price of US$30-40, no longer be viable or only be viable for a significantly shorter estimated field life.

Decommissioning security, which could previously be spread over numerous years of ongoing production, can now only be spread over a much shorter timeframe. As such, more security has to be put aside each year. This is occurring at a time when oil & gas operators are under significant pressure from drastically dropped revenue streams. In addition to there being fewer years of revenue from the field from which security can be drawn, decommissioning may now take place far earlier than previously estimated.

The magnified impact of decreased revenues, increased costs and short CoP timeframe has caused those seeking to protect themselves from potential liability to scrutinise both the current level of decommissioning security in place and the calculations by which the level of future security is defined.

Decommissioning Security Disputes

A typical DSA requires that each year all of the First Tier Participants pay their respective share of (a) "net costs" (representing the best estimated cost of performing all decommissioning activities multiplied by a risk factor); less (b) "net value" (representing expected production receipts from the field) and the amount of security that the participant has already provided.

The estimated decommissioning date and computed risk factor are key inputs when calculating the level of security to be provided. As a result of prior beneficial market conditions, numerous industry participants consider that optimistic assumptions as to future "net value" have historically been made. By making such optimistic assumptions of "net value", the security required to meet estimated "net costs" has been less year-on-year, resulting in the potential for serious under-provision of decommissioning security.

This historic approach, on the part of First Tier Participants, can be explained by their wish to free up cash to invest in production activities or to reduce the asset retirement obligation required so as to leverage themselves further or position themselves for sale.

As a result of current market conditions, Second Tier Participants have become concerned with the adequacy of the security in place. There has been an increase in requests for data, closer scrutiny of projections of "net value" and "net costs", and a greater interest in the use of expert determination in the event that the participants cannot agree.

This is a particular problem for those who entered into Decommissioning Relief Deeds (DRDs). DRDs permit security to be provided on a post-tax basis. Security is, as a result, no longer being paid in at a (higher) pre-tax relief basis. Since October 2013, when DSAs were introduced, this has led to a reduction in both any previously existing decommissioning security "buffer" that resulted from payments having been made on the (higher) pre-tax relief basis, and the absolute amount of security set aside.

With major decommissioning expenditures becoming more of a reality, Second Tier Participants and larger First Tier Participants now seek to ensure that they are sufficiently protected by the security provided. Many smaller First Tier Participants, such as the wave of new-entrant oil & gas operators, on the other hand, are finding increasing costs and falling revenues highly detrimental to their ability to provide the greater levels of security sought.

For these new-entrant oil & gas operators, providing suitable estimates is, on a practical note, an unenviable task. Not only is calculating accurate decommissioning estimates, no matter how carefully done, not an exact science, but smaller oil & gas operators, who are keen to match costs to revenues, have also reduced and/or invested in much needed personnel (such as specialist engineers) and technology (such as decommissioning software).

The recently established Oil & Gas Authority and the UK Continental Shelf Maximising Economic Recovery strategy have only caused further uncertainty. It is less clear now, given the domino impact of neighbouring installations and tie ins, whether an individual installation will be provided the all-clear to decommission as it becomes economically unviable. In such instances, what CoP date should be used, what would the revenues be (if any) and who are to bear the costs? Should such potential costs even be included in decommissioning security calculations? If so, how are they to be estimated?

Conclusion

This is the first year in which the full impact of the oil price decrease will have to be factored in to the annual decommissioning security process. It is inevitable that sensitive commercial negotiations will be needed to ensure that sufficient security is provided. These negotiations should take place early on, particularly in light of this year's deadline (typically 30 June) for providing the requisite decommissioning security estimates, and additional pressure being added by the likely need for unanimous approval from all First and Second Tier Participants.

If such commercial negotiations are unsuccessful, expert determination is the standard method by which parties to a DSA handle disputes between those providing the security and those who remain liable if insufficient security is provided. For more information on expert determination, which leads to a binding decision on the amount of security to be provided, see http://www.squirepattonboggs.com/insights/events/2015/10/expert-determination-what-you-need-to-know.

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