



# **Offshore Oil & Gas Decommissioning in the U.K. North Sea: M&A**

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# Decommissioning Law in the U.K.

- **Legislation:** Petroleum Act 1998, as amended by the Energy Act 2008.
- **Section 29 notice.** Decommissioning obligations arise when the Secretary of State serves a section 29 notice under the Petroleum Act 1998 to the operator of the field and each of the licensees, requiring them to submit a decommissioning programme.
- **Section 34** of the Petroleum Act extends the right to issue a section 29 notice to anyone who, at any time since the issue of the first section 29 notice for the installation, was liable to have a section 29 notice served on it (i.e. former licensees).
- **Section 38(2)** permits the Secretary of State (SoS) to require s29 recipient(s) to provide adequate financial information to enable determination of their capability to meet their decommissioning liabilities. If it is determined that a party is financially incapable, they may invoke s38(4) to require that party to take appropriate mitigating actions including, if required, **the provision of suitable financial security** (which excludes any form of parent company guarantee).
- **Decommissioning programme:** Once the decommissioning programme is approved, section 29 notice-holders are legally obliged to carry it out on a joint and several liability basis. OGA may also serve a section 29 notice on a wider group of parties, not just the current licensees, including any person having an ownership interest in the installation or pipeline, and a parent or associated companies of a licensee.

## Quantum and Scale

- **2015:** £1 billion spent in Norway, £1.1 billion in UKCS on decommissioning in 2015 alone
- **By 2025:** Over 100 platforms, 1800 wells (P&A) and approx. 7500 km of pipeline expected to be decommissioned in the UKCS
- **Significant commercial opportunities:** The expectation is that approximately £17.6 billion is to be spent on decommissioning in UKCS by 2025; there is thus scope for companies to deliver cost efficient and on-budget decommissioning
- **Headache for UK plc:** Government will be making large repayments of taxes previously paid (imposing budgetary pressure). Hence, government is motivated to resolve issue although it faces competing priorities

# M&A Challenge in the UK North Sea

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- Ageing infrastructure
- Technical limits on further recovery
- Regulatory pressure
- High operating costs
- Decommissioning (COP brought forward in low oil price environment)

# The Decommissioning Challenge

## Why is decommissioning a problem?

- **Fields less economic:** Low oil price brings forward COP/decommissioning as fields become uneconomic earlier: Wood Mackenzie forecasts that around 140 UKCS fields will cease by 2020 even if oil prices return to US\$85/bbl (with around 50 fields ceasing even earlier than expected if the oil price returns to a level around US\$70/bbl)
- **High/uncertain anticipated cost:** e.g. the North West Hutton Decommissioning Programme was expected to cost £160m but actually cost £246m – without accurate costing, valuation becomes difficult. For M&A, technical due diligence to probe anticipated decom. process and burden becomes important.
- **Balance sheet burden and security requirements:** DSA's/letters of credit (to be given as security for decommissioning costs) erode balance sheet and reduce debt capacity – particular problem for smaller companies operating in North Sea and private equity funds; this reduces pool of buyers significantly even though these are precisely the entities that could support MER by investing/extending the life of these late life assets and delaying COP/decommissioning
- **Domino effect:** As decommissioning of one piece of infrastructure has a knock-on effect on the economic viability of other fields and accelerates their decommissioning (e.g. Dunlin)); does that mean buyers will need to do due diligence on several linked fields/hubs when making an acquisition?
- **Transferring Tax History:** 'Tax value gap' that exists between buyers and sellers in respect of future decommissioning tax relief. Corporation tax and supplementary charge history does not transfer with an asset. The tax history relating to the asset may be significant, but the buyer cannot factor this into its asset valuation and the buyer may not have enough future taxable profits to shelter future decommissioning cost.
- **Technical risks/heavy regulatory burdens:** OSPAR, Prevention of Oil Pollution Act 1972, Environmental Protection Act 1990 etc.
- **Buyer's universe:** increasingly populated by players with high debt burdens and limited balance sheets; this makes raising finance more difficult (finance providers also wary of funding assets with significant decom. liability/accelerated COP)

# “Clean Break” v Shared Liability – Innovative Solutions Required

- **Pre oil price crash M&A model:** sellers in the UKCS were, **pre oil price crash, often able to negotiate a “clean break”** where the buyer would take on all decommissioning liabilities and provide the seller with security for such liabilities under decommissioning security agreements (DSA)/letters of credit etc.
- **Post oil price crash M&A model:** in a low oil price environment, a “clean break” is difficult to achieve and sellers may need to demonstrate flexibility if MER is to be facilitated and COP of fields delayed; possible risk sharing solutions include:
  - (i) buyer re-transferring asset to seller at point of decommissioning
  - (ii) seller retaining decom. liability (e.g. Ithaca Energy leased the Beatrice offshore facilities from Talisman Energy UK Limited in 2008, including the Nigg onshore terminal and 16” export line from Beatrice to Nigg for a minimum of three years; Talisman Energy UK Limited retained decommissioning liability for the Beatrice facilities under the terms of the lease. )
  - (iii) seller transferring decom liability but providing security on behalf of buyer. Particularly where buyer is pushing out CoP
  - (iv) build up of cash flow from field (to pay for decommissioning)

## Potential challenges to deals:

- How to protect the seller from **s34 liability** e.g. where buyer is of weak financial standing (as is the case for some acquirers)?
- Conversely, how to ensure **seller is solvent/able to take asset back at point of transfer/fulfil decom obligations?**
- How to **value decommissioning cost/risk** – could specialist companies provide more certainty e.g. Fairfield Energy now markets itself as North Sea decommissioning experts

\*Seller retaining decommissioning liability also negates issue of lack of buyer capacity to obtain tax relief for decommissioning expenditure (e.g. private equity funds which do not have relevant profits to offset cost against) and preserves seller ability to claim the relevant tax reliefs (when they start to incur costs relating to the decommissioning expenditure). HMRC has confirmed that companies that retain the decommissioning liability after the sale of an asset will be able to claim corporation tax relief for those costs. However, the position is not so straightforward as regards PRT relief and will depend on the facts and circumstances relating to the asset sale.

# Recent M&A deals – Decommissioning

- **Examples of how decommissioning liability in recent acquisitions were dealt with:**
  - **EnQuest acquisition of 25% interest in Magnus field and operatorship at Sullom Voe terminal (and associated infrastructure) from BP:**
    - BP has retained the decommissioning liability in respect of the existing wells and infrastructure. EnQuest agreed to pay BP further deferred consideration equal to 7.5% of BP's actual decommissioning costs on a post-tax basis (incentivizing EnQuest to deliver decommissioning at a lower overall cost).
    - EnQuest's liability in respect of such deferred consideration capped at the amount of the cumulative positive cash flows received by it from the assets transferred.
    - BP has also granted EnQuest a US\$50 million option to undertake management of the physical decommissioning activities for the Thistle and Deveron fields and making payments by reference to 6% of the gross decommissioning costs of the fields.
  - **Chrysaor acquisition of Buzzard, Beryl, Bressay etc. from Shell:** Shell has retained up to US\$1 billion of an estimated US\$3.9 billion of decommissioning liabilities.
  - **Total acquisition of Maersk Oil:** Total will take over all decommissioning obligations, estimated at US\$ 2.9bn.; a “**clean break**” was probably possible here for the seller due to Total's capacity/resources (which are often not available to independents and private equity funds)
  - **Serica acquisition of 18% interest in Erskine field from BP:** BP responsible for decommissioning costs up to a gross £174 million (£31.32 million net to Serica) adjusted for inflation

# What more can be done to help with decommissioning?

## There is cause for optimism for oil and gas acquisitions:

*“There are tentative signs that investor confidence is starting to return to the oil and gas sector” - Oil and Gas UK Economic Report 2017*

- **Government (facilitate MER):**
  - Section 34 liability
  - ease regulatory burden
  - provide clarity on transferable tax history:
    - Govt. currently considering a TTH in which a seller transfers a portion of its ring fence corporation tax payment history to a buyer, alongside an asset. The buyer could then carry back any decommissioning losses against the TTH, allowing it to receive a tax refund that may otherwise not have been available.
    - Govt. have outlined two options to enable effective PRT relief where the seller retains the decommissioning liability:
      - The licence is deemed to be transferred back to a seller on commencement of decommissioning such that the seller claims PRT relief; or
      - The seller funds decommissioning with the costs being treated as being incurred by the buyer, amending the current anti-subsidy rule.
  - adopt new approaches (e.g. ensure that common infrastructure is maintained and decommissioned in the most efficient way so as to extract the most value from the resource and accept taxpayer will have to bear some additional burden )
- **Private sector**
  - develop more UK wide expertise: some marine engineering companies/oil field service providers are considering models where they take over late life assets from operators towards the end of their life and undertake decommissioning
  - Show flexibility in deals
  - develop insurance solutions: Insurance can currently be taken out for third party property and liability exposures that the operator will face (including abandonment and environmental pollution; is there room for this to expand e.g. **to cover decommissioning warranties/cost over run etc.**)
  - Decommissioning companies could offer cost certainty through fixed price solutions