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Decommissioning in the new era

Decommissioning and security related issues have been one of the principal hurdles to overcome in upstream oil and gas M&A over the last few years. Yet with every threat comes an opportunity. By making the best use of recent developments in the industry and applying an innovative approach, there are options for both buyers and sellers in this challenging marketplace.

With the growing maturity of North Sea assets, and particularly given the recent fall in the oil price, the net revenue remaining in many oil fields might be less than or only marginally exceed anticipated decommissioning costs. Potential buyers do not want to take on liability for decommissioning where there is little if any guarantee of profit at the end of the day, a situation which has resulted in a number of planned sales falling through.

Recent positive developments have, in particular made the provision of decommissioning security more economic. While in the past a request for security might have been made separately by sellers and the buyer's new JV partners, the advent of the industry standard field-wide DSA (Decommissioning Security Agreement) has alleviated the requirement to provide multiple security in the majority of cases. Additionally, the recent contracts entered into between government and industry (decommissioning relief deeds), assuring availability of tax relief on decommissioning expenditure, has allowed buyers to move away from provision of security on a 'pre-tax' to a post-tax' basis, reducing security required by between 50 and 75%.

Nevertheless, given the combination of the increasing maturity of the basin and the low oil price, it is increasingly apparent that many North Sea assets are in the wrong hands, and the medium-term trend in the North Sea which has seen a mixture of smaller 'leaner' companies, infrastructure funds and NOCs (National Oil Companies) looking to acquire assets from the majors divesting elements of their portfolios needs to continue.

Sellers now looking to exit assets, and buyers looking to buy, need to find ever more innovative ways to allocate liability for decommissioning and decommissioning security in order to allow deals to get done, particularly where some buyers cannot meet existing security requirements at a field level. On the sellers' part, while a sale for positive consideration and a clean-break is still the most desirable outcome, we have been involved in several recent sales of assets where elements of decommissioning or decommissioning liabilities have been retained by the seller in order to get deals 'across the line'. The expectation is that the buyer will be able to extend field life through greater investment in upgraded production facilities, infill drilling or tie-backs of satellite fields, which the seller was not prepared to carry out.

Even where the sale price is small or negative there is benefit to a seller in the 'time value of money' that is gained by delaying its decommissioning spend and reallocating its resources elsewhere meantime. There is also a hope that by extending the life of the field, the decommissioning industry will be more developed at the time the decommissioning takes place, resulting in costs savings from the application of new technology and greater economies of scale. Similarly it will be in the buyer's interest to extend field life and receive revenues from on-going production for as long as possible, knowing that it will not be responsible for costs of decommissioning the existing infrastructure at end of field life.

There are a variety of approaches which we have recently explored and used here:

— A sale of the asset and re-transfer to the seller at the point of decommissioning - this may be in the form of an outright sale or a lease. This is simplest for assets where the sellers hold a 100% interest (as otherwise existing co-venturer consent would be required) – a benefit here is that the seller may be better set-up to undertake the decommissioning than the buyer (for example by being able to use existing experience, efficiencies of scale and the like).

— The seller being liable for its (transferred) percentage share of decommissioning of the assets but simply paying the cost at end of field life rather than requiring an asset-re-transfer. While this is the simplest approach, the seller will lose control over decommissioning spend unless it caps its liability or seeks contractual control over decommissioning activities.

— The seller transferring decommissioning liability to the buyer but providing interim credit support in order to secure the costs of decommissioning at a field/ co-venturer level, and obtaining back to back security from the buyer where the buyer cannot meet the co-venturers' security credit requirements. Here the seller would take the credit risk of the buyer's back-to-back security being weaker than its own, knowing that it may be at risk of being liable to co-venturers for the buyer's share in any default.

Key considerations will apply in each of these structures. From a seller's perspective, depending on structure, it may be important for it to have a form of continuing interest in the asset in order to police addition of new facilities, drilling of wells, interim decommissioning, third party tie-ins, transportation and processing arrangements via the transferred infrastructure, ease of termination of field agreements in a hand-back scenario, and others. However, extensive continuing administration required on the part of the seller removes one of the key reasons for selling in the first place, namely the overheads and time dedicated to the relevant asset in its portfolio. What is clear is the fact that there is no standard form – innovative approaches are required.

This is the fourth Foresight article in our Transformation series looking at the future of North Sea Oil and Gas. Discussing various issues from technology to employment and disputes, our sector experts offer their commercial opinions on the future of the industry. Please feel free to forward this Foresight to a colleague or to subscribe to our mailing list here CMSEmployment.Team@cms-cmck.com.

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