

LEGAL

Counting the cost

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Financial distress has been a feature of the oil and gas industry since the precipitous fall in commodity prices in 2014. Licensees owning mature offshore fields have been frequently worst affected. The longevity of an asset is linked to declining reserves, falling rates of production and high costs. Mature fields are, as a result, often described as being marginal. Additional unbudgeted costs such as a decommissioning payment can have a significant impact on the economics of a marginal field.

After a field reaches cessation of production, redundant equipment must be removed. Licensees of depleted fields bear these costs. Prudent stewardship requires that future costs are provisioned out of historic production. In other words, money is periodically put aside for the future costs of decommissioning whilst the field is generating revenue. Such forward-thinking financial planning represents good industry practice. Often it is also encouraged by applicable regulations.

A government's interest in this activity is motivated, in part, by its compliance with international laws designed to protect the environment and users of the sea. As a result of these multilateral obligations, upon a decommissioning default by licensees, a host government would be required to assume responsibility. The industry's current financial distress means

that governments (often acting through their regulators) are particularly concerned to ensure that financial provisions put in place are adequate to meet future obligations.

Decommissioning is in its infancy. With oil prices showing no immediate sign of returning to previous levels, and with a significant number of fields due to cease production in the next few years, the regulations in place governing this subject – and the financial provisions to be put in place – are likely to be tested.

Cash crunch

Developed decommissioning regimes either require, or have an established practice, that licensees pay funds to an independent trustee in advance of cessation of production to provide for future costs. These provisions, otherwise referred to as 'security', may take the form of cash, letters of credit, bank guarantees or other forms of guarantee. All but the most credit-worthy company is likely to be required to cash collateralise a bank for issuing a letter of credit or guarantee. Therefore, even when non-cash security is provided, there is a funding cost incurred several years ahead of the anticipated decommissioning activity.

Funds are required to be put in place pursuant to provisions set out in decommissioning security agreements. The current low oil price environment affects the amount and timing of payments made under these arrangements in several ways.

Security agreements require licensees to start paying provisions once the dollar value of reserves reduces below the estimated dollar cost of future decommissioning.

Estimated decommissioning costs are reduced by a discount rate (to reflect the net present value of future costs of decommissioning) and are increased by a risk factor (to reflect the unpredictable nature of future costs of decommissioning). The point at which the value of reserves is less than costs is known as the 'trigger date' – ie the year in which licensees are required to start provisioning for decommissioning.

As a result of the drop in oil price, reserves are now attributed a lower monetary value. Accordingly, the value of those reserves as a future recoverable revenue stream is reduced and the trigger date when companies start provisioning security for future decommissioning is brought forward. Licensees already suffering from lower sale revenues are, therefore, required to start funding these costs sooner than previously anticipated. Depending on a field's production profile this can involve the provisioning of substantial amounts being brought forward several years. Lower sales revenue plus accelerated decommissioning provisioning is a double blow.

There is also a third potential cost that licensees may incur. Although the risks of operating oil and gas fields are often shared pursuant to a joint operating agreement (a type of joint venture), obligations to the host government (including for decommissioning) are joint. Therefore, in circumstances where one licensee is unable to fund its share of decommissioning obligations, the remaining partners must step in and make good obligations that have not been discharged.

This joint obligation to a host government is reflected in security arrangements. If a licensee is unable to make provisions that are due, then the other partners must pay the shortfall on behalf of the defaulting licensee. A non-defaulting licensee that had previously planned on the basis of paying a certain working interest percentage share of decommissioning provisions may, in these circumstances, find itself paying additional amounts on behalf of a defaulting partner. Circumstances in which one party defaults can quickly produce a downward spiral in which non-defaulting parties are

The current low oil price environment is bringing forward decommissioning plans, although many licensees are struggling to deal with the cash crunch that can ensue

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unwilling (or unable) to assume increased costs. These situations can lead to the early cessation of an existing project.

Industry response

Joint ventures combining dominant financial parties (eg oil majors) with independents have seen the most stress placed on security arrangements. Parties with deep pockets that can afford to provision funds on short notice (or may be sufficiently credit-worthy that they can provision by way of a corporate guarantee) are incentivised to apply financial provisioning requirements strictly to ensure that they are not exposed to the default risk of less credit-worthy partners. Procedures for estimating decommissioning costs and timing are largely operator-controlled and, so, where the operator is also a party with financial strength (as is often the case) it may be incentivised to estimate costs as cautiously as possible. In other words, a financially strong operator is likely to put a higher estimate on future decommissioning costs than a weaker non-operator, and to require these amounts to be provisioned sooner.

Non-operators have little option other than to provision based on an operator's cautious estimates or to commence dispute-resolution procedures. As decommissioning is a new activity, the lack of historic price data from the small number of fields decommissioned to date means that challenging an operator's decision of estimated decommissioning costs may be futile.

Independents have had success when demonstrating to partners that the reduction in offshore contractor rates (that has been a consequence of the oil price fall) should also substantially reduce the cost of decommissioning.

Extending field life – for example, through the use of electrical submersible pumps and other enhanced oil recovery techniques – is a technique that can be used to delay decommissioning. It increases the amount of and therefore, value of reserves. It also decreases the discounted estimated cost of decommissioning by pushing back the anticipated decommissioning start date. However, in times of cash crunch additional capital expenditure is hard to justify and difficult to fund. Joint venture voting procedures mean that unwilling parties may be compelled to join such projects, or conversely willing parties may be

unable to procure other partners to vote in favour.

Situations become even more complex if parties in a joint venture are debt financed – in creditors' eyes, loan repayments take priority over decommissioning provisioning or additional capital expenditure.

Negative equity conundrum

If a resolution can't be found to this cash crunch by any particular joint venture, partners may be forced to default by not provisioning amounts when due. In negative equity situations where the expected costs of decommissioning are equal to, or exceed, the expected future revenue, the traditional remedy for default situations of forfeiture of the defaulting party's participating interest is inadequate. Forfeiture in these negative equity situations forces non-defaulting parties to elect whether to take on additional liabilities merely to keep the project going. If no non-defaulting party elects to accept the forfeited interest, the joint venture is terminated, triggering cessation of production and an immediate acceleration of decommissioning.

As yet, no satisfactory legal solutions have been found to these default situations given the terms of existing security arrangements. To better deal with this issue in the future, better monitoring of existing provisions will be required. Looking to the next oil price cycle, decommissioning security agreements for new fields should be drafted to provide for more regular updates to decommissioning estimates and more frequent calculations of the provisioning trigger date.

Reform options

Governments are beginning to recognise the importance of decommissioning and the issues it raises.

The UK's Oil and Gas Authority (OGA), for example, recently issued its decommissioning strategy, setting a target of reducing decommissioning costs by 35% from a 2015 base. UK decommissioning costs between 2015 and 2050 have been estimated at £47bn, so cost savings in excess of £15bn could be seen if this target is achieved.

Well abandonment, post-cessation operating expenses and infrastructure removal are identified as areas where cost savings can be made. These are estimated as currently constituting 70% of total costs. Beyond these savings, broader strategies

identified by the OGA include:

- Creating demand-led decommissioning forecasts which should allow the coordination of more cost effective decommissioning campaigns across multiple assets.
- Finding ways to facilitate asset transfers to lower cost operators.
- Encouraging the development of new, cheaper, decommissioning technologies.

US regulators have been increasingly willing to allow oil and gas platforms to be toppled in place to be converted into artificial reefs (known as the 'rigs-to-reefs' programme). This brings substantial cost savings and, in the eyes of some stakeholders, can provide better economic outcomes. It remains to be seen whether other regulators will move in this direction and permit derogations from the long-standing international principle that, other than for a narrow set of exceptions based on engineering difficulties involved in decommissioning, offshore oil and gas infrastructure should be entirely removed.

Future focus

Security agreements have been an important development in offshore oil and gas. They protect parties from credit risk and ensure that environmentally-necessary decommissioning can be paid for. Importantly, they protect governments (and consequently taxpayers) from bearing the cost of removing disused infrastructure. However, the recent cycle of low oil prices has shown that improvements can be made.

Hopefully the worst of the financial distress has passed. However, to avoid the same problems in the next cycle, regulators need to focus on finding environmentally appropriate ways of reducing the costs of decommissioning. Rigs-to-reefs programmes and facilitating coordinated decommissioning campaigns are a good start. Furthermore, joint venturers need to find a more dynamic process for provisioning funds. More frequent and independent processes for estimating decommissioning costs and calculating the provisioning trigger date should become the norm. ●

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