Department for
Business, Energy
& Industrial Strategy

ASSESSING THE FINANCIAL CAPABILITY OF OFFSHORE OIL AND GAS COMPANIES TO DELIVER DECOMMISSIONING OBLIGATIONS

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Contents

Assessing the financial capability of offshore oil and gas companies to deliver decommissioning obligations

Status and Purpose

This guidance sets out how and when government will assess the financial capability of a person or class of persons with a relevant interest in, or a potentially relevant interest in an offshore oil and gas installation, pipeline and connected wells, to deliver decommissioning obligations and the factors that will usually be taken into consideration when doing so.

It outlines how we assess the financial capability of persons with a relevant interest in or considering taking an interest in an offshore oil or gas field for the purposes of satisfying the Secretary of State that that person will be capable of carrying out a decommissioning programme in relation to that interest. It describes the financial assessment process that supports decisions to give and withdraw decommissioning notices and explains how the government identifies, assesses and manages risks associated with decommissioning liabilities.

Policy

Operators of oil or gas installations or pipelines are required to decommission infrastructure at the end of a field’s economic life. Our policies and processes are set out in our Guidance Notes: Decommissioning of Offshore Oil and Gas Installations and Pipelines (November 2018).

This guidance note explains the steps government takes to ensure that the taxpayer is not exposed to undue risk from companies' defaulting on their obligations leaving government and the taxpayer with the decommissioning responsibilities.

Government must be confident that each group of companies with an interest in an offshore oil or gas installation (including connected wells) and pipeline is always capable of meeting their decommissioning liabilities (regardless of when that liability may be realised).

We expect owners of offshore installations, connected wells, and pipelines to have adequate financial planning arrangements in place to meet decommissioning liabilities.

We also expect that the owners responsible for a field at the end of its economic life, will undertake decommissioning in accordance with our published guidance notes and will pay for decommissioning.

We therefore regularly assess the financial capability of operators, their joint operating agreement partners and other parties with decommissioning liability to meet their decommissioning obligations, reviewing each field on its own merit.

The assessment process takes a systematic approach comprising of a series of financial tests that consider the capability of the company to meet its decommissioning obligations with the objective of ensuring that decommissioning costs would still be met in the event of the insolvency of one or more persons responsible for decommissioning.

This guidance note explains how that question is addressed at various stages over the life of a field explaining the financial tests that are undertaken, how risks are identified and how the government uses powers set out in the 1998 Petroleum Act ("Act") to mitigate risks it deems to be unacceptable.

Legislative Background

Notices under section 29 of the Act may be given to those persons with an interest of a kind set out in section 30 (1) of the Act in respect of each individual offshore installation on the UKCS and section 30 (2) of the Act in respect of each individual offshore pipeline. These section 29 notices require the recipient to submit a decommissioning programme at such times as the Secretary of State may call for it.

A section 29 notice may be withdrawn under section 31(5) of the Act. It should be noted that such a withdrawal is granted at the discretion of the Secretary of State. The circumstances under which withdrawal is considered are detailed below.

Further information regarding the serving of notices setting a decommissioning obligation is available in section 3 of Guidance Notes: Decommissioning Offshore Oil and Gas Installations and Pipelines (November 2018).

Assessing the financial strength of companies to deliver their decommissioning obligations

The financial assessment process starts when an operator prepares a Field Development Plan (FDP) and continues throughout the life of a field. Routine financial checks are undertaken three or four times each year for every field with an approved FDP in the UKCS and may be done more frequently if information on circumstances that might have a detrimental impact on the economic performance of the field or the financial strength of the company is made known. Financial checks are also undertaken when interests in a field are bought or sold.

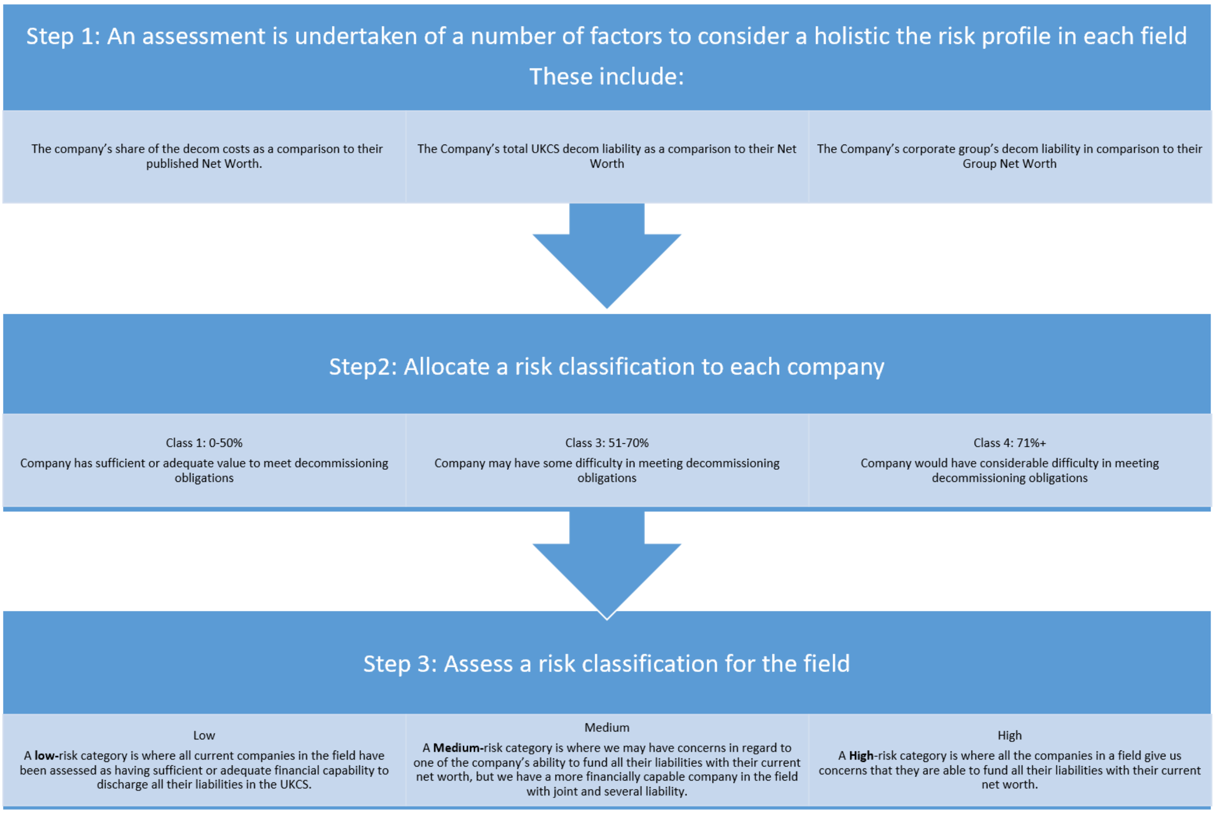
Periodic review ensures that updated company accounts and wider changes in a company's and their group's portfolio of assets are taken into account and where necessary mitigation measures instigated. During these reviews particular attention is also given to exited companies that have sold their interest in an asset and not had their section 29 notice withdrawn to determine if the decision remains appropriate.

Where a company has requested withdrawal of their section 29 notice following the transfer of their interests in a field, they will be informed whether the Secretary of State will exercise his discretion to withdraw. Where the notice has not been withdrawn at that stage but a periodic review of the risk assessment indicates withdrawal is now appropriate, the relevant companies will be informed. In addition, we are always willing to take account of new information or material changes that impact the risk assessment for specific section 29 groups. Companies should contact OPRED to discuss any relevant updates to their cases. The assessment process is treated as confidential and will only be discussed with the company concerned.

The assessment process is a relatively simple process used to assess the risk of all section 29 groups and the mechanistic tests are not the end of the process. Where necessary OPRED will review the company's finances in more detail and take account of the prospects for revenues from the relevant fields. In addition, where factors, such as a sudden change in company status, have a material effect on the risk, a detailed review will be undertaken. This may alter the initial risk assessment and the resultant need for mitigation measures.

Field Risk Assessment

Each field is assessed on its individual merits and a risk classification is assigned to all the companies involved in the field, the current owners and separately the previous owners who retain liability in the field are assessed. This assessment is undertaken using a number of factors to consider a holistic view of the risk profile in each field. This is a staged process which is not exhaustive.



Step 1: Assessment of liability in relation to company value

The first step involves tests that compare the decommissioning costs for the field to company value as assessed by the net worth of the company and any corporate group.

OPRED undertakes its own assessment of decommissioning costs, currently using data provided by external consultants. The estimates are based on a deterministic approach where vessel costs, manhour costs and estimated time durations are used from a broad experiential assessment of how decommissioning has been undertaken and the averages and norms for individual parts of the work breakdown structure, making assumptions for potential OSPAR derogations. The information is only used in the financial assessment process and is not published, however specific cost estimates for individual fields can be shared with the owners and where appropriate we may amend the costs used in the risk assessment to reflect the owners estimate where evidence supports this. Guidance on estimating decommissioning costs has been developed by OGUK and is available from the Oil & Gas UK website (www.oilandgasuk.co.uk).

Net worth is calculated from information provided in published accounts based on shareholder funds/equity minus intangibles of both the company and their corporate group.

Stage 1 - The factors considered in a financial assessment include:

A calculation of the company's share of project decommissioning costs, based on their percentage share of the licence, compared to its published net worth, and this is expressed as a percentage.

A calculation of the company's share of their total decommissioning liability across the UKCS as a percentage of its net worth.

A calculation of the company's corporate group share of decommissioning liability across the UKCS as a percentage of the corporate group's published net worth.

Step 2: Company Risk Classification

The second stage in the process uses the information from stage 1 to allocate a risk classification to each company for each of the different tests, using the following parameters:

Low risk company – 0-50% Company has sufficient or adequate value to meet its decommissioning obligations and discharge their liabilities in the UKCS.

If the estimated decommissioning costs for a field are less than or equal to 50% of the published net worth of the company or of the corporate group to which it belongs, we would consider that there are adequate resources to meet those costs when they crystallise.

Medium risk company – 51-70% Company where we may have concerns in regard to the company's ability to fund all their liabilities with their current net worth, but the company group or a more financially capable company are involved in the field which should have adequate funds to meet the total decommissioning obligations.

High risk company – 71% + -Company would have considerable difficulty in meeting decommissioning obligations. If the liability exceeds 70% we would consider that the company/group would have considerable difficulty in meeting the decommissioning costs.

Note: If a company is categorised as medium or high-risk from a decommissioning perspective then further analysis will be undertaken.

Step 3: Section 29 Group Risk Classification

Once a classification has been assigned to each company it is possible to assess the risk to the field overall.

Whether a section 29 group is low, medium or high risk will depend on the balance of company's risk in the field. The classification assumes companies are registered in the UK. If a company is not UK registered it may be discounted when determining the group classification:

Low risk section 29 groups: If there is a company that is considered low risk in the field, as they can easily afford both their share of the decommissioning costs of the project and their wider UKCS costs, we are likely to conclude that the section 29 group is low risk. Alternatively if all companies involved are medium risk, but their funds are still considered adequate the section 29 group could be given a low risk allocation.

Medium risk section 29 groups: Similar to low risk, if there is a company that is considered to be medium risk in the group but there is a wide spread of ownership of medium risk and based on a balance we are likely to conclude that the section 29 group is medium risk.

High risk section 29 groups: If a low or medium risk classification is not justified, by default the section 29 group will be high risk.

In addition to the above examples the strength of the corporate groups of the companies will be considered. The involvement of one or more corporate groups with significant resources may be sufficient to allocate a lower risk classification to the section 29 group.

Assessing the financial capability of a company with regards to decommissioning

Where we have financial concerns about a section 29 notice holder we may undertake a secondary and more in depth assessment to review the financial risk associated with the company's portfolios of UKCS interests. This may be driven by the risk classification as noted above or may be undertaken where a material change in a company's status has been highlighted through the media, other intelligence or another source. This is explained in more detail below.

A financial capability assessment considers the ability of a company to meet its decommissioning obligations. This involves an assessment of each field as set out above as well as a wider review of the company taking into consideration the following, but not limited to:

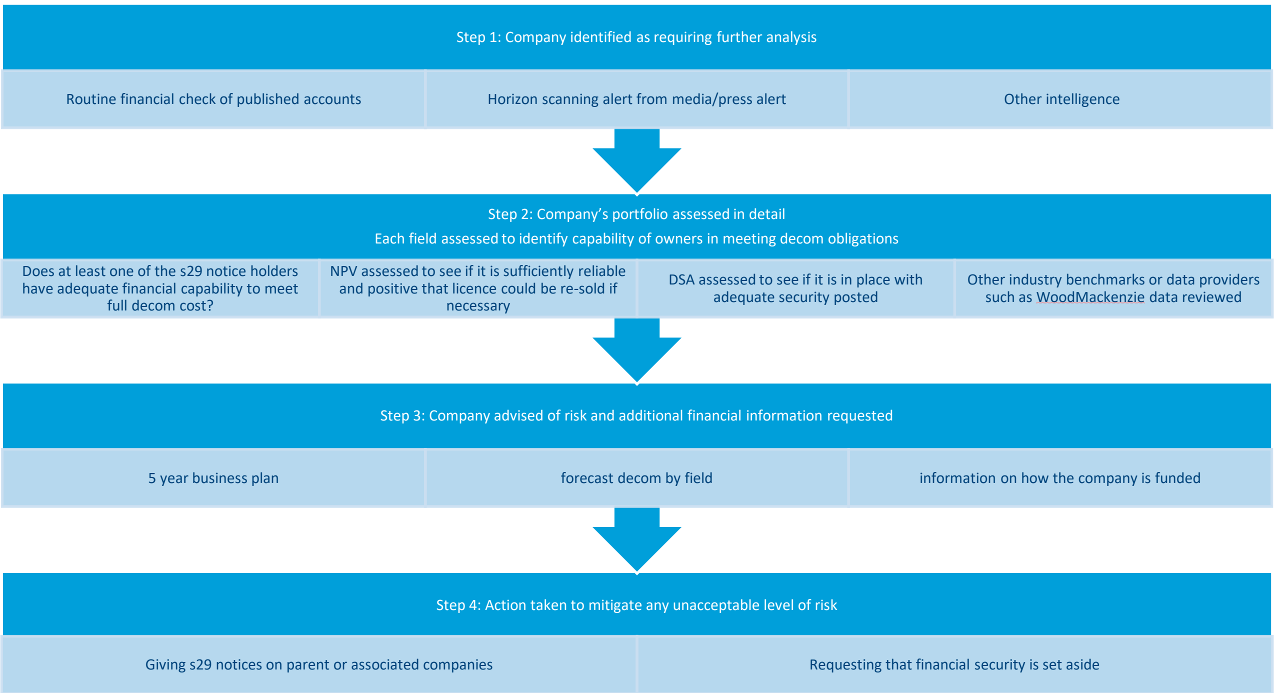
- financial check of latest published accounts for the company and parent company
- the estimated cost of decommissioning the installations and pipelines associated with each field
- the net present value of field(s)
- other industry benchmarks or data
- company business plan

Details of financial plans that are in place to meet decommissioning costs as well as capital expenditure commitments.

The assessment process takes a systematic approach comprising of a series of financial evaluations that consider the capability of the company to meet its decommissioning obligations. The tests consider the financial stability of the company and seek to respond to the question of what would happen to specific fields in the event of company failure.

If we conclude that there is a risk that the current parties with an interest in a field may be unable to meet their obligations, the risk may be mitigated by giving section 29 notices more widely in accordance with our statutory powers, to parent or associated companies, or we may request financial security to be set aside, in an appropriate format, to meet the decommissioning liability associated with the field.

Overview of Financial Capability Assessment and Risk Mitigation Options



The assessment is in the form of analysis of a series of potential mitigations of risk, as illustrated in the following four steps:

Step 1: Company is identified as requiring further analysis.

There are a number of potential triggers that could highlight that a company require further analysis. For example:

Routine financial checks that assess the published net worth of a company. Step 2: Company Risk Classification, on page 6, explains how a risk classification is assigned to each company. If a company is identified as being high risk through this process as secondary assessment may be undertaken.

Horizon scanning may highlight an event or issue for a company or field that has potentially detrimental financial implications for a company. Examples include, company re-financing, unexpected drop in production, sale or purchase of an interest in a field. This list is not exhaustive and there are a range of factors that may prompt further analysis.

Other intelligence. Information can come from other sources that merits further investigation, this can include inter alia information from other government departments or agencies, and knowledge of capital expenditure projects which impact finances.

Step 2: Company portfolio review

Where a company is identified as requiring a secondary assessment each field they have an interest in is reviewed to identify the capability of the field owners to meet the decommissioning liability for the field. There are multiple factors to consider at this stage:

- Review of all current owners in the field to consider whether the presence of one or more financially strong company provides sufficient risk mitigation from a decommissioning perspective, answering the question “what would happen in the event that the “high-risk” company failed”? If there are other current partners in the field with a lower risk classification we are likely to be satisfied that industry will meet the decommissioning obligation and may not see the need to pursue further risk mitigation.

- Review of any previous owners retaining a section 29 notice to see if their financial strength demonstrates capability to meet decommissioning obligations for the field.

- Review of additional financial and market intelligence on the “high-risk” company, and the “high-risk” field(s), considering the net present value of the field(s) concerned, using market intelligence and any other information in the public domain or potentially requesting financial information directly from the company.

- Review of existing security arrangements in the field to assess whether sufficient funds are held securely to meet decommissioning obligations.

If these tests do not provide sufficient comfort that industry has adequate funds to meet their decommissioning liability we would need to take further action to mitigate risk for the taxpayer.

Step 3: Additional financial information requested from company.

At this stage in the process the company will be advised of our assessment and will be asked to provide additional information. Where necessary the Secretary of State may use powers under section 38 of the Act requiring specified information or documents relating to the financial affairs of the company.

Information to be provided is likely to include:

Five year business plan for the company to provide detail on the future plans of the company, looking at liquidity, gearing, capacity to borrow, and the assumptions that underpin the business plan.

Decommissioning estimates for each field that the company has an interest in

Information on the company structure and its details of its investors or lenders

The information provided at step 3 enables an appropriate risk mitigation measure to be put in place.

Step 4: Action to mitigate risk

There are two key powers in the 1998 Act to help mitigate the financial risk associated with decommissioning for the taxpayer. Firstly, the power to give section 29 notices to a wide class of persons, including parent or associated companies, and secondly, where appropriate, to require financial security for a field. Where an unacceptable level of risk has been identified both risk mitigation options will be considered.

- Where a parent or associated company has sufficient net worth, we may apply section 30(1)(e) of the 1998 Act in respect of installations or section 30(2)(c) in respect of a pipeline and give a notice under section 29 to the relevant parent or associated party. This assessment will take into consideration the country in which the parent/associated company is domiciled.

- We may consider requiring financial security for the field in accordance with section 38(4) of the 1998 Act which enables the Secretary of State to require a company to provide security if they have been served with a notice under section 29 or have a duty to carry out an approved decommissioning programme. This is normally done in the form of a decommissioning security agreement.

Giving and Withdrawing Section 29 Notices

When the OGA agree to an assignment of interests in a licence affecting an approved field, OPRED will give notices under section 29 of the 1998 Act on the buyer (if they do not already have such a notice). Using the field risk assessment process described in the section Field Risk Assessment, OPRED will also consider whether the Secretary of State should exercise his discretion under section 31(5) to withdraw the section 29 notice(s) from the selling party/parties. This process is also used where a company has requested withdrawal of their section 29 notice following the transfer of their interests in a field. However in the vast majority of cases the section 29 notice is unlikely to be withdrawn from the selling party/parties.

OPRED is willing to take account of new information or material changes that impact the risk assessment for section 29 holders and companies should contact OPRED to discuss any relevant updates to their cases. The assessment process is treated as confidential and will only be discussed with the companies concerned.

New Field Developments

New fields may be developed by companies with limited financial resources and OPRED may be concerned about their ability to fund decommissioning, especially if something should go wrong in the early phase of the development. When a developer puts forward proposals for a new field, we will assess the financial strength of the companies involved, using the stepped process outlined above and taking account of any additional information relevant to the case. Each assessment is confidential but OPRED will always be willing to discuss it with the company and would take into account any proposals to establish security.

At this stage we are primarily considering the risk of premature decommissioning resulting from disappointments in the performance of the reservoir or installation and financial changes in the company, and therefore financial liability potentially falling to the tax payer. As with existing fields, if we feel that the field is high risk a notice under section 29 may be given to associated parties and, if the risk remains high, we will consider whether to require the provision of security.

Where security has been provided, we will reassess the position after an agreed period of production to decide whether to suspend the security requirement as satisfactory field performance and assurance of future revenues has been demonstrated. In such cases, we may expect to re-instate the security closer to the end of field life as the field reservoir depletes. The net value of the remaining recoverable reserves and the financial position will be reviewed and discussed with the company.

Asset transfer - buying and selling of interest in a field - change of control or license transfer

When an asset sale is agreed for a field, we will assess the financial strength of the company involved, using the stepped process outlined above and taking account of any additional information relevant to the case. Each assessment covers the individual fields as well as the portfolio of decommissioning liability. OPRED will also seek to meet with the new entrant to discuss our process for financial risk assessment and understand their plans going forward.

Once a classification has been assigned to each company it is possible to assess the risk of the group of notice-holders as a whole, i.e. the section 29 group risk. This should be calculated both with and without the presence of any outgoing party to consider the impact.

Whether a section 29 group is low, medium or high risk will depend on the balance of companies and their individual risk calculations and is undertaken in the same way as detailed in the section Field Risk Assessment. The classification assumes companies are registered in the UK. If a company is not UK registered it may be discounted when determining the group classification.

In addition the strength of the corporate groups of the companies will be considered. The involvement of one or more corporate group with significant resources may be sufficient to allocate a lower risk classification to the section 29 group.

We may look at prospects for future revenues from the relevant fields and will always discuss the assessment with the company if it wishes to do so. We will not disclose our assessment outside OPRED or the company concerned without its permission.

Annex 1 - Decommissioning Security Agreements to which the Secretary of State is a party

General Background

The Secretary of State is party to a number of decommissioning security agreements (DSAs).

A template DSA and associated guidance are available from the Oil & Gas UK website www.oilandgasuk.co.uk. Although OPRED will also consider security agreements that do not utilise the DSA template they would need to meet the same minimum requirements and ensure that security is ring-fenced to be used for decommissioning.

The over-riding aim of a DSA is to ensure that guaranteed funds (which may include future revenues in appropriate cases) will be available to cover the decommissioning costs at all times. For example, if a company becomes insolvent before decommissioning, the security posted under the DSA would be held in trust until triggered. The Treasury's introduction of the Decommissioning relief deed gives surety of decommissioning tax relief and one of the aims of this is to move security to a post-tax basis in DSAs. Where a decommissioning relief deed has been granted and the company has a relevant tax history OPRED requests security on a post-tax basis. This security requested from each affected party will be equal to the insolvent participant's post-tax share of the decommissioning costs, which may be reduced or discounted by an allowance for their share of any remaining oil and gas reserves and the operating expenditure that would be spent in recovering those reserves, in line with a formula contained in the DSA. This formula underpins the DSA and have to be recalculated regularly by an independent third party to ensure that the levels of security are realistic and up to date.

The Secretary of State may seek to become a party to an existing DSA or to instigate a DSA if he considered there is substantial unmitigated risk in a particular field. As a party to the DSA the Secretary of State can ensure that changes cannot be made without his written consent and take action to resolve a default situation. Any proposed changes to the agreement, in the event of a licence assignment, for example, would require a separate approval from the Secretary of State.

It is also conceivable that in the event of a default by all the other parties to a DSA, the Secretary of State may need to arrange decommissioning and draw on the securities arranged by the parties.

The Secretary of State's interest is to ensure that in the event of company insolvency that decommissioning securities are protected to meet the decommissioning costs for the field.

Minimum Requirements for a DSA to which the Secretary of State is a party

Where it is assessed that there in an unacceptable level of risk that a company may not be financially capable of meeting its decommissioning obligations in accordance with section 38(4) of the 1998 Act the Secretary of State may require an appropriate level of financial security is set aside. While a DSA is not a mandatory requirement most companies prefer to sign a bilateral DSA with the Secretary of State. Where the Secretary of State requests security it must be in the form of cash, irrevocable standby Letters of Credit (LoCs) issued by a Prime Bank or on-demand (performance) bonds from Prime Banks or issued by an Insurer regulated under the Financial Services and Markets Act 2000. For these purposes the security must be issued by a body established in an EU or OECD country with a UK lending or insurance office and which have an A- or better awarded by Standard and Poor's or Fitch or A3 or better awarded by Moody's or an equivalent rating by another recognised rating agency.

Prior to issuing a notice requiring the provision of security the Secretary of State has a statutory requirement to consult with the Treasury and give the company an opportunity to make representations regarding whether they should receive such a notice. A company which fails to comply with a notice under section 38(4) will be guilty of an offence unless they can prove that they exercised due diligence to avoid the failure. In deciding the best way forward in such a situation, the Secretary of State will consider the reasons for the default and continue to look for mechanisms to protect the taxpayer. Where security has been provided in accordance with a notice and the security provider is down rated during the period covered by the security, the Secretary of State will discuss any necessary action with the company. The required action will depend on the new rating and continued standing of the security provider.

The DSA should be on a full field basis, and where more than one operator/owner is a party, should establish a mechanism to allocate a share of the costs to each party. The security should cover each party's share of the post-tax costs of decommissioning the installations and pipelines in the relevant field. In the event of default, although obligations remain joint and several, in the first instance other parties are expected to cover the share of the default proportionate to their percentage interest.

If a Decommissioning Relief Deed is in place and there is a relevant tax history the security should be provided on a post-tax basis (decommissioning costs after decommissioning tax relief) including site clear-up after the main removal work. In most cases it will also be necessary to add a risk factor to cover the uncertainties surrounding cost calculations. The need for and the amount of this will vary depending on the complexities of the facilities to be decommissioned but in most circumstances will add around 10 - 30 % to the total cost estimate. Unless one party owns 100% of the interests, where the field concerned is in production and future revenues can be reasonably predicted, allowance would be made for those revenues on a post-tax basis. However, salvage value of the equipment can only be discounted if the security covers an FPSO type facility which has real intrinsic value. Following completion of the main removal activities ongoing security to cover the site clear up activities will be required (this amount will be in the range of 1-3% of the total decommissioning costs). Further information on the formula to be used to calculate the costs of decommissioning is contained within the template DSA and its accompanying guidance notes, at the Oil and Gas UK website.

Unless alternative forms of security are agreed, the DSA should provide for the security in the form of LoCs, escrow accounts, on-demand performance bonds or similar, to be renewed annually, 2 months before the next period of security is due to commence. In the event of the failure by any party to renew security before the next period, that party would be in default and the LoC or performance bond would be triggered and the money drawn down and deposited in a regulated Trust Fund to accrue interest until it is needed to pay for decommissioning costs.

The DSA should be drafted to ensure that any potential liability of the Trust Fund to inheritance tax is accounted for in the calculation of the amount of security.

Unacceptable Security

Parent Company Guarantees (PCGs)

PCGs are not an acceptable form of decommissioning security as they do not meet the criteria of being irrevocable and on-demand.

A standby letter of credit imposes a primary contractual obligation on the issuer to pay a specified sum of money on the happening of a specified event. It can be argued that a PCG is related to the underlying contract and is not therefore a primary obligation on the part of the guarantor. There remains, therefore, the possibility that the guarantor might dispute the basis on which the obligation in the underlying contract has arisen which could result in the matter becoming the subject of litigation.

In some cases the parent company may not itself have the long-term financial strength we are looking for and in cases where a subsidiary is in financial difficulty this may indicate that the parent and/or group as a whole is in financial difficulty, as the need for the security to be called upon is most likely to arise in cases where the group as a whole is in financial difficulties. Moreover, in such cases, if the guarantor cannot or will not pay up under the guarantee, the remaining participants would be left without any easily accessible assets to cover the defaulting licensee’s share of decommissioning costs. This might therefore expose the Secretary of State to the risks involved in trying to recover decommissioning costs from overseas parent companies.

Independent Audit

Estimates of decommissioning costs and of the net value of remaining recoverable reserves used to calculate the required levels of security must be carried out at least every 3 years and may be required annually depending on the project timescales. An independent third party expert approved by OPRED must verify this audit process. Further details about the timing and frequency of such audits are contained within the template DSA.

Independence of the DSA

The DSA must be a stand-alone document, entirely independent of the JOA (although the terms are sometimes referenced in the JOA) and any other similar agreements.