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The UK's Decommissioning Security Agreement: Securing the Future Today

Sean Rush examines the UK's international obligations with respect to the decommissioning and disposal of offshore oil and gas facilities, and how these obligations are passed on to international oil companies.

The UK Government has accepted that its international obligations with respect to the decommissioning of offshore oil and gas facilities requires, in general, the dismantling and removal of offshore facilities and disposal onshore. In 2005 The PILOT Brownfields Studies group estimated the cost of such decommissioning as being in the range of £15 to £19 billion. Oil & Gas UK's more recent estimates are £19 billion by 2030 and £23 billion by 2040. Accordingly, while Department of Energy and Climate Change ('DECC') are mandated to encourage new, if smaller and less creditworthy, international oil companies ('IOCs') to extract the remaining reserves on the UKCS, the UK's tax authority (HMRC) is concerned that the decommissioning liability to the UK tax payer will crystallise when domestic production and associated revenue is low.

To ameliorate HMRC's concerns, the UK's domestic legislation provides for the IOCs' receiving revenue from an installation to be primarily liable for the costs of its decommissioning. To manage this liability, an industry work group was formed from members of Oil and Gas UK, the UK's offshore industry association (formerly UKOOA). The working group, in combination with DECC, feedback from HMRC and legislative support, have developed a pro-forma Decommissioning Security Agreement ('DSA') which provides a framework for the funding of decommissioning obligations in a manner that balances the interests of stakeholders and provides certainty to new investors, the Government and exiting IOCs. It was published for consultation in September 2007 and last updated in March 2009.

This paper considers the UK's international obligations with respect to the decommissioning and disposal of offshore oil and gas facilities. It analyses how the UK's international obligations for the removal of facilities are passed on to the IOCs through the Petroleum Act 1998. It considers standard joint operating agreement ('JOA') provisions that allocate liability for decommissioning and funding thereof and goes on to review the overall structure of the DSA and how it facilitates compliance with the UK's international obligations whilst encouraging the extraction of the remaining reserves on the UKCS.

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DECOMMISSIONING UNDER THE APPLICABLE LEGAL FRAMEWORKS

International Legal Framework

The UK's international obligations with respect to offshore installations are derived from the United Nations Convention on the Law of the Sea of 1982 ('UNCLOS'). Article 60(3) includes the following: 'any installations or structures which are abandoned or disused shall be removed to ensure safety of navigation, taking into account any generally accepted international standards established in this regard by the competent international organisation.'

The 'competent international organisation' cited in UNCLOS is the International Maritime Organisation ('IMO'). In 1989, the IMO adopted a Resolution (A.672(16), 19 October 1989) with annex on 'Guidelines and Standards for the Removal of Offshore Installations and Structures on the Continental Shelf and in the Exclusive Economic Zone'. In summary, the guidelines require the removal of: (i) all installations standing in less than 75 metres of water and weighing less than 4000 tonnes; (ii) all installations placed on the seabed after 1 January 1998, standing in less than 100 metres and weighing less than 4000 tonnes; and (iii) installations located in primary navigational routes. However, neither UNCLOS nor the IMO Guidelines give explicit direction on how to dispose of disused installations leaving the option of deep sea disposal open.

In 1992 the Convention on the Protection of the Marine Environment of the North East Atlantic ('OSPAR') was agreed, clarifying the legal obligations for the participants with respect to the disposal of offshore installations. OSPAR came into force on 25 March 1998 pursuant to OSPAR Decision 98/3. As a regional convention, it applies to specific areas of the North East Atlantic, including the UKCS part of the North Sea. The key features of the OSPAR Decision 98/3 are:

(i) The top sides of all installations must be returned to shore;

(ii) All installations with a jacket weight less than 10,000 tonnes must be completely removed for reuse, recycling or final disposal on land; and

(iii) The footings of large steel jackets weighing more than 10,000 tonnes and concrete installations may be subject to a derogation recognising the difficulty of their removal. However, the presumption is that they will be removed entirely and the derogation only applies to the installations installed before 9 February 1999.

As such the UK Government has accepted that its international obligations will result in the great majority of offshore installations being returned to shore with very few exceptions justifying the exercise of the derogation.

The Energy Act 2008 provides that Section 29 Notices may only be served upon parties that are entitled to derive a financial or other benefit from the installation.

UK National Legislative Framework

The main statutory instrument in the UK regulating decommissioning is the Petroleum Act of 1998 (the 'Petroleum Act') and in particular sections 29 to 45. Section 29 entitles the Secretary of State to serve notices (a 'Section 29 Notice') requiring the recipient to submit a statutory decommissioning programme for approval at such time as the Secretary may direct. A Section 29 Notice relating to a particular field and associated facilities is usually issued to the immediate Licensees, which will include the Operator at the same time the Secretary approves a field development plan. However the Secretary is also entitled to serve the Section 29 Notice on other persons where DECC consider that satisfactory arrangements will not be made with respect to decommissioning. Section 30 lists the persons who could conceivably be the recipients of a Section 29 Notice:

(i) the person having the management of the installation (i.e. the Operator);

(ii) persons with a right to exploit or explore mineral resources in any area, or to store gas in any area and to recover gas so stored, where such exploitation, exploration, storage and transportation are, or are intended to be, carried on from, by means of or on the installation (effectively the Licensees);

(iii) any party to the JOA relating to such rights (usually the Licensees);

(iv) persons who own any interest in the installation other than as security; and

(v) any company associated with any of the persons previously mentioned (i.e. affiliates and parent companies).

Whilst the list of recipients seems extensive in response to industry representations, it was restricted by the Energy Act 2008. The Energy Act 2008 provides that Section 29 Notices may only be served upon parties that are entitled to derive a financial or other benefit from the installation. This provision was added due to the widespread practice on the UKCS of numerous field developments by unassociated joint ventures but under a single Licence. In these circumstances joint venture owners of one field may not be parties to the JOA regulating other fields in the area covered by the Licence but could still be held liable for the decommissioning in those areas due to the joint and several liability owed to the Secretary under such Licence.

Nevertheless, holders of a Section 29 Notice, whether they continue to be Licensees or not, remain jointly and severally liable to carry out the decommissioning programme relating to the facilities listed therein. Furthermore, even in circumstances where the Section 29 Notice has been withdrawn it can be reissued to a former holder and a 'secondary' liability will remain on their associated companies, amongst others, pursuant to Section 34 due to the power of the Secretary to serve a Section 29 Notice on any person who could have been a recipient at anytime previously.

In summary, the Government has passed its liability under OSPAR on to the IOCs via the Petroleum Act. The division of those obligations between the IOCs will be regulated by the underlying JOA and performance secured by the associated DSA.

The DSA ameliorates a dilemma faced by the industry: how to encourage new entrants to extract the remaining reserves in mature fields without their creditworthiness creating an exposure for Government or exiting IOCs.

DECOMMISSIONING UNDER JOINT OPERATING AGREEMENTS

Provisions relating directly to decommissioning in JOAs have been traditionally brief. Understandably, joint venture participants have not considered it a sensible use of time or resources to negotiate the detail of Security Agreements in advance of any discovery. However, the rights and obligations of each of the JOA Participants under a Licence will be defined by reference to their equity share or Participating Interest. In this manner, the joint and several liability that each of the Participants owe to the Government under the Licence, including the decommissioning liability, is divided amongst themselves on a several, and not joint, basis. Whilst the liability between themselves is defined, the security for performance of each Participants liability is left open, save for reference to the default provisions in the JOA that will have limited value at the end of field life. The common practice is for there to be a simple statement that the Participant's will agree a decommissioning (or abandonment) programme and other arrangements at some later stage. The enforceability of these 'agreements to agree' is questionable.

For example, the AIPN's Model International Operating Agreement 2002 provides in Article 10.3 *Abandonment Security* for the Participants to agree to negotiate a Security Agreement prior to the application for an 'Exploitation Area' (essentially a field development approval). The Security Agreement is to incorporate principles relating to the provision of security at a future date when the discounted net value remaining in the project equals a proportion (to be agreed) of the discounted net costs associated with decommissioning.

The Oil and Gas UK Model JOA is similarly brief. Clause 26 contains four clauses but importantly references the entering into of the DSA as annexed to the JOA as Schedule C prior to the submission of a development plan. As such, the effort associated with negotiating the detail of a Security Agreement has been largely removed facilitating the conclusion of firm security arrangements that are acceptable to Government and industry alike.

In addition, the DSA ameliorates a dilemma faced by the industry: how to encourage new entrants to extract the remaining reserves in mature fields without their creditworthiness creating an exposure for Government or exiting IOCs. Historically, while the UKCS industry was made up by majors that were well known to the Secretary and abandonment (as decommissioning was historically referred to) a long way away, it was common practice for a Section 29 Notice to be withdrawn on the transfer of interest in the Licence and underlying JOA to a third party. However, in more recent times with the advent of smaller and new start companies and the exit by many of the majors from some of the larger fields, both the Secretary and the major operators have been concerned to ensure that there is sufficient creditworthiness amongst the remaining holders of the Section 29 Notices in order that the decommissioning obligations are discharged, avoiding secondary liability. As such we have seen a move towards Secretarial objection of the withdrawal of Section 29 Notices and the refusal by remaining Participants to execute novations of JOAs before a transfer completes unless security for decommissioning has been put in place.

The industry has devised the Decommissioning Security Agreement as an industry and Government approved pro forma that provides a transparent and balanced approach to the provision of decommissioning security.

This has had the undesirable effect of discouraging new entrants, who specialise in reworking older facilities and extracting the remaining reserves, due to the costs of such security and difficulties in concluding satisfactory arrangements in a timely manner. As such, the industry has devised the Decommissioning Security Agreement as an industry and Government approved pro forma that provides a transparent and balanced approach to the provision of decommissioning security.

THE DECOMMISSIONING SECURITY AGREEMENT

Overall Structure

It is contemplated that the DSA is to be annexed to Oil & Gas UK's Model JOA upon execution although it can act on a standalone basis. It is envisaged that the DSA be executed prior to the filing of a field development plan. At a time (the 'Trigger Date ') when the Net Value remaining in the field is equal to or less than the remaining Net Costs, including those associated with decommissioning, as escalated by a risk factor to be agreed (commonly 120% - 150%) a trust will be constituted with a third party as Trustee and each party will be required to contribute a sum (the 'Provision Amount') to the trust on an annual basis from the Trigger Date until the 'End Date' which is after decommissioning is completed and stated as being 12 months after the submission to the Secretary of a 'Close-Out Report'. The period between the Trigger Date and the End Date is known as the 'Run-Down Period'.

The calculations for Net Cost and Net Value are made by the Operator pursuant to the 'Decommissioning Plan', which the Operator is obliged to provide annually commencing the year before the Run-Down Period. The Decommissioning Plan will include the calculations for Net Cost and Net Revenue and must be approved unanimously or be referred to an Expert.

With respect to paying for the costs of decommissioning, it should be noted that funds residing in the Trust are simply security. The obligation to make payment pursuant to invoices in the usual way under the JOA remains the primary method of collecting funds to complete the Decommissioning Plan.

Parties

To deal with potential secondary liability faced due to the ability of the Secretary to confer liability upon persons that are not immediately involved in the field, the DSA provides for Second and Third Tier Participants. Second Tier Participants are those who remain as holders of a Section 29 Notice and accordingly remain jointly and severally liable for decommissioning even after exiting the Licence and JOA. These persons may become parties to the DSA and beneficiaries under the Trust. Third Tier Participants are those who could have been recipients of a Section 29 Notice and therefore may become jointly and severally liable by operation of Section 34. These persons may not become party to the DSA but may enjoy the benefit of the security afforded to them due to the operation of the Contracts (Rights of Third Parties) Act 1999.

The nature of the UK's international obligations are such that the Government remains the primary obligor at an international level under OSPAR for the removal of decommissioned offshore installations.

The Secretary of State may also join as a party and may choose to do so in order to ensure amendments are not introduced that significantly reduce the security offered.

The DSA has been drafted to fit with the JOA but it can be adapted to dovetail with a sale and purchase agreement that seeks to transfer an interest in the JOA provided the transferee provides security pursuant to the DSA.

Alternative Security

Whilst the DSA envisages cash being held under Trust, alternative security ('Alternative Provision') can be made by the parties. These include the provision of a letter of credit, corporate bond or parent company guarantee ('PCG') in the forms annexed to the DSA. DECC requirements for letters of credit are for a credit rating equivalent to AA (Standard and Poors) or Aa2 (Moodys) although the work group recommended the slightly lower ratings of AA- and Aa3. It should be noted that DECC does not accept PCGs or parent bonds due to issues of enforceability against foreign companies and EU state aid rules for UK domestic companies.

Default

Default events are triggered, generally, by the failure to provide or maintain the security to the requisite amount or credit rating. However, a default under the JOA will also trigger default under the DSA.

The usual remedy of forfeiture of Participating Interest applies, subject to rights to remedy a default. This will entail the defaulting party's Participating Interest being transferred to the non-defaulting parties in addition to any sum held by the Trustee as security. If the defaulting party has not provided the full Provision Amount then the amount outstanding will be left as a debt due to the non-defaulting parties.

Due to the operation of Section 38A of the Petroleum Act, all sums set aside as security for decommissioning under the DSA will be protected from creditors in insolvency.

Miscellaneous

The DSA provides detailed provisions for Expert selection and related rules and annexes the form of Alternative Security, Trust Deed, the List of Second Tier Participants and other documents. These pro forma annexures along with the mechanisms required to create and maintain the Trust Fund go a long way to eliminating the time and expense otherwise required to conclude a DSA in the early stages of Licence appraisal or when completing a transfer of Participating Interest.

CONCLUSIONS

The nature of the UK's international obligations are such that the Government remains the primary obligor at an international level under OSPAR for the removal of decommissioned offshore installations in accordance with the 'polluter pays' principle, the Government has transferred that obligation through to the IOCs under the Petroleum Act at a time when new and smaller industry players are needed to extract the remaining reserves that are of no interest to the major players. The dynamics between facilitating easy entry to the UKCS and the transfer of decommissioning liability from existing IOCs to new entrants has caused friction, not only between new and exiting IOCs, but also between different branches of Government.

The DSA provides a transparent solution by enabling the cost of decommissioning security to be factored into any acquisition and goes some way to addressing IOC concerns that the Secretary may transfer its liability for decommissioning under OSPAR to the IOCs under the Petroleum Act as a secondary liability should the immediate Licensees default. Whilst secondary liability has not been eliminated, the DSA allows exiting IOCs, as Second Tier Participants, a right to monitor and, if necessary, enforce the provisions of the DSA and recognises the position of Third Tier Participants. As a result the provisions enable the IOCs to self-regulate the liability for decommissioning in accordance with the polluter pays principle by providing a layer of insulation between primary and secondary liability and effectively eliminates liability for the Government and, by extension, the taxpayer.

ABOUT THE AUTHOR

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