MATURE OPERATIONS

Addressing the generation gap

***Marc Hammerson*, Partner, Akin Gump Strauss Hauer & Feld, and *Jonathan Day*, Assistant General Counsel, Perenco, review comparative issues between frontier and mature basins.**

There is understandable enthusiasm about discoveries in the world's newest hydrocarbon basins. Countries and regions such as Guyana, East Africa and the Arctic command disproportionate attention in comparison to their small current output. Oil companies are eager to book additional reserves from these new jurisdictions. Local stakeholders are excited about potential tax receipts, job creation and energy security resulting from exploitation of their resources.

In contrast, countries that have been producing for several decades face different challenges. The 'easy oil' has already been exploited and, in comparison to both historic discoveries and those found in frontier countries, new fields brought into production tend to be smaller.

All basins eventually reach a point when the size and frequency of new discoveries are insufficient to replenish reserves. At this stage regulators focus on maintaining production levels from existing fields, with policies aimed at maximising tax and safeguarding jobs. For example, a city may seek to promote its accumulation of expertise to expand its client base and serve as a hub meeting international, rather than merely domestic, demand. Aberdeen provides an example in the oilfield services sector.

Decommissioning costs – for both producers and, indirectly because of tax refunds, governments – also become a concern for producing countries once output begins to decline and field cessation dates draw closer.

Regulators address these issues with contrasting policies and levels of success. Despite a country's excitement over impending production and societal benefits, all basins eventually need to address challenges similar to those being dealt with in parts of the world today. Current experience in the North Sea, Gulf of Mexico, onshore Nigeria and similar basins provide examples of both good and bad practice. In the UK, the regulator recently published policy documents intended to extend the life of the domestic offshore industry and satisfy a statutory obligation to maximise economic recovery (see p18).

Old age benefits

Before considering challenges faced by mature basins and policy responses, it is worth noting some mitigating benefits. Longevity produces several advantages:

- Because of historic activities, a basin's geology is understood. Explorers are therefore better able to assess sub-surface risk.
- For natural gas, there may be an existing domestic market able to facilitate bankable long-term offtake arrangements or sales into a liquid spot market.
- Pipelines, onshore terminals and tie-back facilities may already be in place. The use of existing infrastructure may be critical to the economics of a future field development. If owned by a competitor, this requires agreeing rights of third-party access. In order to promote new developments in mature basins, regulators may encourage owners to grant third parties capacity rights in existing infrastructure.
- In relation to procurement challenges, a local services industry may already be established in the domestic market, resulting in an active market place for oilfield services at competitive prices.
- As well as pricing, local practice may have developed standardised agreements between service providers and operators that facilitate low transaction costs, transaction speed and contractual familiarity (in the UK, examples include industry-led initiatives such as LOGIC).
- To the extent that one can associate mature basins with Europe and North America (an assumption which generally holds, with some exceptions), compared with similar examples from frontier jurisdictions, merger and acquisition (M&A) transactions in mature basins are typically quicker, more contractually standardised, apolitical, incur lower transaction costs and are at less at risk of failure due to the exercise of third-party pre-emption.

These benefits and cost savings give mature basins comparative advantages. As a result, a marginal discovery may enjoy a greater likelihood of being declared and remaining economically viable than would be the case for a similar field in a frontier jurisdiction. In the global marketplace for investment capital, these are benefits that, together with fiscal and regulatory stability often found in mature basins, are attracting specialist late-life producers, start-up companies and private equity. New participants often fill the space left by oil majors which, in part motivated by the desire to increase reserves on their balance sheets, are selling late-life assets in order to focus resources on larger prospects in under-explored countries.

Problems of old age

The changing nature of participants serves, however, to accentuate certain industry-wide concerns in mature basins. The withdrawal of oil majors and replacement by less financially strong companies creates credit risk. A party with only a small working interest in a field is liable, if its partners default, for amounts owing by the joint venture in its entirety. The industry's standard remedy – namely, forfeiture of a defaulting party's interest – acts as adequate compensation only if the value of the interest being forfeited exceeds the liability. This is typically the case at the early stages of a field's life.

With significant exploration and development costs having been spent but decades of production yet to be recovered, the threat of forfeiture of a defaulting party's future entitlements serves as both an effective deterrent to discourage default and sufficient recourse to a non-defaulting party if it occurs.

However, as reserves decline (as a result of natural depletion), revenues fall (as in the current commodity price environment) and end-of-life costs are incurred (due to decommissioning expenses), forfeiture becomes a less effective remedy. At some point, a field enters negative equity as future anticipated expenses exceed anticipated revenues. Knowing that this will occur, regulators and industry legislate and contract to ensure that parties do not renege on obligations. A key policy requires parties to provide annually for decommissioning costs prior to cessation of production.

Good practice requires that an escrow account is funded by the joint venture to ensure that financial provisions are set aside to pay for future decommissioning expenses. It is an inefficient allocation of capital if provisioning occurs too early. Typically companies start contributing annual amounts after a date when the value of unproduced reserves equals 125% to 150% of estimated decommissioning expenses. This practice, which is long-established in the UK North Sea, has generally been a success and has withstood financial distress throughout the industry caused by a prolonged downturn in oil prices. However, notwithstanding the UK's robust regulatory framework, there are examples of companies having under-provided for future decommissioning expenses and disputes arising.

State assistance

What role do regulators play in ensuring the success of a mature basin?

Firstly, regulators can mitigate price uncertainty by ensuring that the market for decommissioning services functions efficiently. Offshore decommissioning is in its infancy and the lack of a tested market makes estimating final costs an inexact exercise (and also the timing and amounts to be set aside). If unduly conservative in making cost estimates, this uncertainty results in an over-provisioning for future costs and an inefficient allocation of capital. If unduly optimistic, this uncertainty results in an under-provisioning for future costs and potential risks that a counterparty is unable to meet future obligations.

The UK regulator, the Oil and Gas Authority, has recently promoted cost savings in the decommissioning sector by the creation of benchmarks and metrics. By working closely with industry it hopes to share lessons and develop innovative approaches to contracting strategies. The regulator also intends to improve collaboration, for example by promoting information exchange and reducing costs by allowing multi-operator plugging and abandonment campaigns.

Secondly, regulators can encourage M&A. Basin longevity is promoted if assets are held by parties enthusiastic about continued ownership. Existing owners often become tied into a field due to an inability to sell. This can be caused by difficulties in obtaining third-party consents and other rights (such as pre-emption) that dampens the attractiveness of a sales process. As well as ensuring that their own consents to corporate transactions are quick and transparent, regulators can also exercise rights to approve commercial documents to ensure that parties do not include contractual rights to disrupt M&A activity.

Finally, a regulator can assist in the promotion of rights of third-party access. This is achieved by setting out principles about sharing of information, timely negotiations, settlement of disputes and resolution of conflicts of interest. The desired outcome is that parties negotiate rights of third-party access at fair and reasonable tariffs and terms, and based on known spare capacity. If these principles are not met then the regulator needs the power to resolve disputes. But normally the mere threat of regulator involvement is sufficient for parties to agree.

These and other principles ensure that mature basins enjoy a long life and produce fiscally and commercially-optimal outcomes. ●

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