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Update

MER UK draft strategy

The draft **MER UK Strategy** was issued by DECC for consultation on 18 November 2015.

As this document will have a very significant impact on the UK Continental Shelf (**UKCS**) upstream oil & gas industry and how it conducts its business going forward, we urge you to review this draft Strategy (along with the draft of the **Energy Bill** currently making its way through the House of Commons).

Oil & Gas UK (**OGUK**) is currently preparing a draft industry response which they will circulate shortly. If you wish to provide your comments to OGUK, please do so by noon on Monday 7 December. You may also wish to give an independent written response to:

MER UK Strategy Consultation
William Culter, Area 4C
3 Whitehall Place
London SW1A 2AW

woodreviewimplementation@decc.gsi.gov.uk

The consultation period will close on **8 January 2016 at 11:45.**

Introduction to the MER UK Strategy

The Department of Energy & Climate Change (**DECC**) is obliged to produce this Strategy by 12 April 2016 under the Petroleum Act 1998 and, to ensure this date is met, DECC's intention is to lay the Strategy before both Houses of Parliament in early 2016. There has been an "informal" workshop held in Aberdeen prior to the issue of the draft Strategy and a further workshop was held in London on 24 November 2015.

The Strategy is intended to meet the Principal Objective of "*maximising the economic recovery of UK Petroleum*" as set out in s 9A(2) of the 1998 Act.

The critical point to note is that the MER UK Strategy will be legally binding on "relevant persons" who are required to act in accordance with the Strategy, namely The Oil & Gas Authority (**OGA**); offshore licence holders and operators, and persons planning and carrying out commissioning of upstream infrastructure. It applies to offshore licences, Wytch Farm and onshore terminals. As currently drafted, it does not apply to drilling companies nor other service providers. There is a proposed amendment to the Energy Bill, however, which, if passed, will extend the Strategy to owners of offshore installations. It is thought by OGA to be inappropriate to extend the Strategy to service providers. That is seen as a step too far, especially as OGA has no direct legal relationship with the supply chain.

The Strategy provides the benchmark against which operators will be judged by OGA and, if OGA considers that benchmark is not met and the Strategy is breached, then the new sanctions and enforcement powers which OGA will be given in the Energy Act may be invoked.

At the London workshop it was stressed by OGA that it was not the Regulator's intention to be autocratic or bureaucratic in the enforcement of the Strategy but to work in partnership with the industry. Although there was an acceptance that

the Strategy may be seen by some as a little draconian, in its enforcement, OGA is not going to be a "dictatorship". It wants to work with the industry to increase net value and encourage investment.

So, does the black letter of the Strategy provide that comfort to the industry?

Key provisions of the Strategy

The Strategy consists of a Central Obligation, Supporting Obligations, Safeguards, Required Actions and Behaviours and, in the Introduction, a set of high level principles to which regard has been had in drafting the obligations. Although this is not made clear in the Strategy itself, in Part 2 of the consultation paper it is confirmed that the principles are not legally binding and are included for interpretive effect to "*clarify the nature of the obligations created in the Strategy*". It is also not made clear within the Strategy that the Central Obligation and Supporting Obligations are intended to be subject to the over-riding Safeguards. It is our view that further drafting is required to clarify these points.

The principles

The following non-binding principles have been considered by OGA when drafting the obligations:

- Stakeholders are obliged to maximise "*expected net value*" not expected volume
- Compliance is intended to lead to investment and operational activities which will add net value to UK
- Compliance may require companies to reallocate (redistribute) value between them leading to greater value overall – but not all companies will be better off
- Compliance should not require companies to invest or operate where there is not a "*satisfactory expected commercial return*" – low risk investment could give low return
- OGA must balance the immediate benefit of economic recovery with the need to maintain long-term confidence of investors

The "*expected*" value or return is a recurring theme but the word is not defined. OGA has confirmed that "*expected*" is intended to include a risk-adjusted rate of return but that should be clarified by adding a definition of this term. It is a very subjective test and there has been a lot of debate as to what should be included in this economic analysis and what view OGA will take, for example, on the future oil price.

Central obligation

This obligation is at the core of MER UK. As currently drafted, it states that:

> ***"Relevant persons must, in exercise of their relevant functions, take all steps necessary to secure that the maximum value of economically recoverable petroleum is recovered from the strata beneath relevant UK waters"*** [Emphasis added].

MER has been expanded to refer to maximum value (rather than maximum volume). This obligation on the relevant persons applies to the entire UKCS and not just to individual fields. A requirement for individual companies to "*take all steps necessary*" to maximise value for the greater good of the UKCS is certainly pretty onerous and potentially draconian. Applying a strict interpretation, the current wording envisages a lengthy list of steps which have to be taken, including by OGA as well as licence-holders and operators. It has been suggested that the obligation needs to be so extreme so that the industry takes the Strategy seriously – a wake-up call. The wording does not, however, reflect the Principles listed above and it would be preferable in our view if the requirement was to take all "reasonable steps" or "all commercially reasonable steps".

When questioned about the all-embracing nature of this obligation, OGA says the intention is to limit the extent of the obligation by the Safeguards referred to in the Strategy (see below). This is not clear from the document and, if that is indeed the intention, the paragraph requires to be amended to put this beyond doubt.

"*Economically recoverable*" is defined in the Strategy as "*those resources which could be recovered at an expected (pre-tax) market value greater than the expected (pre-tax) resource cost of their extraction, where costs include both capital and operating costs but exclude sunk costs and costs (like interest charges) which do not reflect current use of resources. In bringing costs and revenues to a common point for comparative purposes, a 10% real discount rate will be used*".

We have the same issue here about what is meant by "*expected*" in this definition.

We are told that "*economically recoverable*" is the threshold above which the Strategy applies. If the resources which could be recovered do not meet this definition, then OGA has no remit. This standard does not just apply to what might be economically recoverable by a licensee or infrastructure owner but the maximum value which could be recovered by any person. The licensee/owner will be judged against whether another company could recover the petroleum more efficiently or cost-effectively.

Safeguards

The Strategy sets out some fundamental safeguards for the industry which are intended to modify the Central and Supporting Obligations, although that needs to be made clear in the drafting. The safeguards are as follows:

- No Strategy obligation permits or requires conduct otherwise prohibited by legislation, including HSE legislation

The intention here is that nothing in the Strategy should cut across the existing regulatory regimes. Other relevant legislation will include, for example, competition law. In responding to the DECC consultation, the issue to highlight is whether the list of relevant legislation should be

expanded, whether there should be a reference to "including but not limited to" or no reference to any specific legislation.

– No Strategy obligation requires any person to make an investment or fund activity where they will not make a "*satisfactory expected commercial return*"
– Similarly, where in the opinion of a company the commercial return required is higher than offered by a specific project and are minded not to undertake the project, OGA will discuss this with the company

"*Satisfactory expected commercial return*" is defined as "*a reasonable post-tax return having regard to the risk and nature of the investment*". According to DECC's consultation paper, this is a deliberately flexible definition to encompass all the multitude of factors that have to be taken into account before deciding to invest.

A company may not be required to invest in projects which do not meet this test and if the project does not meet the test, OGA will not be involved. It has to be noted, however, that, if in OGA's view an investment or activity could prove to be commercially viable and, following discussions, the company cannot or is still unwilling to proceed, OGA may require the company to divest the licence/assets at a fair market value to allow another company, who is willing and able to take the project forward, to do so.

– No Strategy obligation requires any conduct where the benefits to the UK are outweighed by damage to long-term confidence of investors

OGA understands that continued investment in UKCS is essential to meeting the MER objective. This Safeguard mirrors the provisions in the Energy Bill whereby OGA has to have regard to providing a stable and predictable system of regulation that encourages investment.

It may be appropriate to add some further safeguards relating to data information management although OGA has taken the view that this is adequately covered in the data provisions in the Energy Bill.

Supporting obligations

The Strategy also contains supporting obligations which are legally binding on the relevant persons and which are intended to provide some clarity as to what steps are needed to fulfil the Central Obligation in specific circumstances. The supporting obligations relate to exploration, asset stewardship, technology and decommissioning.

Exploration

The licensee must plan and undertake activities (including seismic and drilling) of a type and manner which is optimal for "maximising the value of economically recoverable petroleum" that can be recovered from the region.

If the licensee has made a firm commitment to carry out a work programme, it cannot surrender the licence until completing that programme. But, if such activity does not provide a satisfactory commercial return, the licensee may carry out a similar work programme, or a programme as agreed with OGA, to meet the Central Obligation. This could be in respect of another licence held by that licensee.

A licensee shall be obliged, therefore, when planning exploration to give consideration to what activities other licensees may be carrying on in the region and how collaboration with seismic, drilling and other activities might fulfil the Central Obligation. "*Region*" is defined as "*any area within relevant UK waters within which it is reasonable to expect that collaborative action could contribute to the fulfilment of the Central Obligation*". So licensees now have to consider what is happening beyond their own licence block.

OGA says it understands that in some circumstances drilling a well is pointless or a safety risk and it is not appropriate to proceed. In that event, the suggestion is that a similar work programme could be transferred to another licence held by the licensee. Quite how that works in practice is unclear. Could the work programme be transferred to another licence in which there are different co-venturers? This is a point which requires clarification by OGA.

In passing, we note that the 29th Licensing Round (frontier licences) is due to be released in Q1 2016 with six months being given to evaluate the seismic data captured by OGA.

Development

In the field development stage, when planning and constructing infrastructure or considering use of existing infrastructure, an operator must give due consideration to the optimal geographical placement and type of infrastructure to be used and whether it could be of benefit to other operators in the region in order to achieve the maximum value of economically recoverable petroleum. The operator could be required by OGA to make some reasonable adjustments to the infrastructure, for example construction of an over-sized pipeline. OGA says that those benefitting would have to pay for the adjustment but, once again, that safeguard is not set out in the Strategy.

It is understood that the operators will be asked to demonstrate fulfilment of this obligation through the field development plan and close liaison with OGA. Once again, OGA says that they are not going to be too bureaucratic in their approach to compliance. It will not be a question of having to tick boxes but more a matter of having "the right conversations with the right people" within OGA, bearing in mind the intention is to create value rather than bureaucracy.

Asset stewardship

There is an obligation on owners and operators of infrastructure to ensure it is maintained and operated to achieve optimum levels of performance, including production and cost efficiency, for the duration of production.

The infrastructure must be operated in a way that achieves maximum value not only in the field but also in the region. This includes allowing access to infrastructure on fair and reasonable terms and, where the infrastructure cannot cope with demand, prioritising access in a way which maximises value recovered.

Technology

This is a wide obligation to use technologies (including new and emerging) best fitted to maximise value, including technology for decommissioning. In deciding which technology to use, regard has to be had to the risks and uncertainties and the potential long-term benefits to the UK of development of such technologies.

It is not intended for OGA to get actively involved in developing such technologies. They say that there is evidence of available tried and tested technologies not being used by companies. There is no intention, however, that companies will be forced to use prototype technology. Companies will be encouraged to collaborate closely to trial new technology, for example to test its application in one well. If successful, it will be for the benefit of the UK.

As with the government-funded project to gather seismic data, OGA was asked whether the government would be involved in seeking out and investing in technological developments but confirmed that, in all probability, it will not happen. OGA, however, referred to the existing government agency, the Technology Strategy Board (now Innovate UK) which, since 2007, has invested over GBP 1.5 billion in innovation, matched by a further GBP 1.5 billion in partner and business funding. They have helped more than 5000 innovative companies in projects estimated to add GBP 7.5 billion to the UK economy. There are also other government agencies which might assist with funding. One of the big problems, however, is the industry failure to use the technology available. Now companies will be challenged by OGA as to why they are not using such technology.

Competition law is also relevant to the collaboration and sharing of technology, especially in relation to decommissioning. OGA say they are not a competition regulator but, if they consider behaviour is anti-competitive, they are duty-bound to report it to the CMA. They understand that breaching competition law is a serious concern for the industry in meeting MER and, in particular, the collaboration obligations. OGA has confirmed that it has started the process of discussions with the CMA with a view to producing clear guidance as a matter of priority.

Decommissioning

Before commencing decommissioning of infrastructure, the owner is obliged to explore all options for its continued use, including transport and storage of carbon dioxide, and to do so on a regional rather than an individual field basis.

In relation to carbon capture and storage, the opposition amendments to the Energy Bill in the House of Lords last month proposed extending the scope of Principal Objective of maximising the economic recovery of UK petroleum to providing for carbon capture and storage. Views have been expressed, however, that predicted the amendment will not be passed in the House of Commons. Indeed, following the announcement to the stock exchange on 26 November 2015 that the GBP 1 billion government funding to develop new technology for capturing and storing carbon dioxide has been cancelled, there is now no committed public support for carbon capture and storage. Shell and SSE had been developing a scheme to capture carbon output in flue gases at Peterhead power station and pump it into disused North Sea gas fields but that scheme will not now progress.

Decommissioning of infrastructures must be carried out in the most cost-effective way, giving due regard to the technology obligation referred to above. This will involve the potential for co-operating with other owners and operators in the region to share and, thus, reduce costs overall. Once again, demonstration that this obligation has been met will be a matter of discussion with the decommissioning team at OGA which includes economists.

Required actions and behaviours

In addition to the Central Obligation and the Supporting Obligations, the Strategy sets out certain conduct which companies must meet to demonstrate compliance with the obligations. This code of conduct will be used by OGA to measure the extent to which companies have met their obligations. The required conduct set out in the Strategy is:

Compliance in a timely fashion

Compliance with the obligations must be in a "*timely fashion*". OGA will rely on this provision, for example, in relation to examining the duration of contract negotiations and whether there is undue delay impacting on the Strategy.

Collaboration

Where collaboration or co-operation with others with interests in the region could reduce costs and/or increase recovery of economically recoverable petroleum, companies must give consideration to such collaboration and must also co-operate with OGA.

Cost Reduction

In order to meet the obligations, there is also a requirement that the full lifecycle costs of recovery of petroleum be reduced as far as possible. This is difficult to achieve, however, when the service providers/supply chain are not covered nor bound by the Strategy.

Relinquishing assets

Companies must invest or will be required to divest if they are unwilling or unable to meet MER. This applies in all circumstances including where recovery generates unsatisfactory returns, where suitable finance cannot be raised or for technical reasons. If a company has to divest, it cannot ask for anything other than a fair market value or reasonable terms and conditions so that another company, which is able and willing to invest, is not prevented from doing so.

OGA confirmed they will not become involved in the sale process. What represents a "fair market value" is subjective and there is no guidance as to how OGA will make that judgment. If there is only one offer, will that be taken to be the "fair market value"? Will companies be forced to sell below market value and will buyers take advantage of the position? If a company is viewed by OGA as holding out for an excessive amount and preventing another company who is willing and able to meet the Strategy obligations, then ultimately OGA can revoke the licence.

OGA plans

Finally, OGA is empowered to draw up "plans" in the future which set out OGA's views on how any of the obligations should be met. These plans may relate to the development or decommissioning of one particular area or region(s) of the UKCS and will flag up to the industry areas of particular interest and OGA's vision of how particular obligations are to be met.

The nature and extent of the "plans" are not defined. The OGA plans are not legally binding and, prior to publication, OGA "may" first have to consult with industry or those affected by the proposed plan. It appears that OGA has a discretion to consult but it would be preferable if consultation was mandatory.

Conclusion

It is recognised that DECC/OGA have had a very difficult task to perform in drafting this Strategy. As presently drafted, the Strategy is very onerous but that may be because it has been drafted purposefully at such a high level. We understand that OGA plans to issue guidance to the Strategy at some point in the future, based on practice and experience. In the meantime, OGA has said it would welcome and will seriously consider any industry comments on the drafting. Indeed, the current draft may undergo further changes once the Energy Bill is enacted.

Whilst safeguards are in place which are intended to over-ride the Strategy obligations, licensees, operators and infrastructure owners are required to take in to consideration not only what might meet these obligations in relation to their own assets but also projects involving other companies' assets in the region and for the overall good of the UK. It is impossible to know at this stage how OGA is going to analyse and interpret what is "*economically recoverable*" or a "*satisfactory expected commercial return*" and what the industry will require to do to demonstrate compliance with the Central and Supporting Obligations. Whilst collaboration is already taking place, the extent that it breaches competition law is still uncertain. How OGA will wield the ultimate power to require divestiture at a "*fair market value*" and how that value is to be assessed is also uncertain.

OGA considers that one of the strongest safeguards for the industry is that companies under the Strategy are not obliged to do anything which might have short-term benefits for the UK tax payer but the benefits are outweighed by damage to the long-term confidence of investors. That really depends, however, on how rigidly OGA interprets and applies the Strategy and what requirements it makes of the industry.

For the most part, we are hearing all the right noises from OGA by way of reassurances as to how they intend to implement the Strategy. We are told that the sanctions and enforcement powers available to them under the Energy Bill will be invoked very much as a necessary last resort and OGA's main role will be as a facilitator, encouraging co-operation and collaboration. It has to be said, however, that compliance with the "black letter" of the Strategy is daunting for the industry and the uncertainties may well serve to discourage investment in the basin.

Further information

If you would like further information on any issue raised in this update please contact:

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