

UK North Sea: New Fiscal Stimulus to Oil and Gas M&A Transactions

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The offshore UK Continental Shelf (“UKCS”) has been producing oil and gas for more than 50 years. Although, based on the Oil & Gas Authority (“OGA”) estimates there is still up to 20 billion barrels of recoverable oil remaining, as is inevitable in a mature basin, there is an increasing number of assets that have either ceased or are approaching cessation of production. The trade association Oil and Gas UK estimate that 100 fixed structures, 7500km of subsea pipeline and approximately 1800 wells will be decommissioned in the UKCS over the next decade.

Many UKCS operators are currently facing the question of how to monetise end of life fields in their portfolios and determining whether to push out cessation of production, decommission or sell these assets. The cumulative factors of rigid legislative and fiscal regulatory regimes in a low price environment have led to a sluggish M&A market. Buyers and sellers in transactions involving end of life fields are having to look for commercially innovative solutions of addressing decommissioning liability for these mature assets.

The Finance Bill that received Royal Assent on 12 February 2019 introduced two key changes to the UK tax regime that aim to incentivise new investment in older oil and gas fields and infrastructure and maximise economic recovery:

1. A new measure providing a transferable tax history (“TTH”) mechanism and amending the Petroleum Revenue Tax (“PRT”) rules on retained decommissioning costs, which extends to buyer tax relief on decommissioning costs
2. Amended anti-subsidy rules so that where the seller provides the buyer with funds for decommissioning the buyer will be entitled to tax relief

In the UKCS, decommissioning is a continuing, joint and several liability that passes with the asset and that may extend to a wider group of entities than the current licensees. Owners of oil and gas installations and pipelines are required to decommission their offshore infrastructure at the end of a field’s economic life and the Petroleum Act 1998, as amended by the Energy Act 2008 (the “1988 Act”) requires owners to set out the measures to decommission disused installations and/or pipelines in a decommissioning programme.

Decommissioning obligations arise when the Secretary of State (the Secretary) serves a section 29 notice under the 1998 Act to the operator of the field and each of the licensees, requiring them to submit a decommissioning programme. The Secretary has the power to issue a section 29 notice to a potentially much wider group of entities beyond current licensees, including previous licensees, any person having an ownership interest in the installation or pipeline, and a parent company or associated companies of a licensee. Once the decommissioning programme is approved, section 29 notice-holders are legally obliged to carry it out on a joint and several liability bases.

The ability of oil and gas operators to access tax relief on their decommissioning costs has historically depended on the extent of their tax payment history, which in some circumstances reduced the pool of potential buyers (especially in case of new entrants to the UKCS). In recent years we have seen the emergence of a new category of buyers, represented by private equity and small to mid-cap independents, many with high debt burdens and limited balance sheets, making raising capital more difficult as financiers are wary of funding assets with significant decommissioning liability or accelerated cessation of production.

Before TTH, on an asset transfer deal (as opposed to a share disposal) the parties had to reach an agreed position on allocation of responsibilities with respect to decommissioning liabilities. Negotiations generally focused on a “clean break” for the seller versus shared liability. For example, Total assumed all decommissioning obligations, estimated at US\$ 2.9 billion, upon its acquisition of MaerskOil. A “clean break” is more likely for a seller in circumstances where the buyer, like Total, is well-capitalized, which is often not the case when independents and private equity portfolio companies are the buyers.

For example, both BP and Shell retained a proportion of decommissioning liabilities on their disposals to EnQuest and Chrysaor, respectively. When BP sold its 25 percent interest in the Magnus field and operatorship at the Sullom Voe terminal (and associated infrastructure) the parties agreed on a complex mechanism with BP retaining decommissioning liability in respect of existing wells and infrastructure as well as a considerable element of deferred consideration tied to an agreed percentage of BP’s actual decommissioning costs on a post-tax basis. Likewise, Shell retained up to US\$1 billion of an estimated US\$3.9 billion of decommissioning liabilities when it sold multiple fields, including the mature Buzzard, Beryl and Bressay fields to Chrysaor.

The introduction of TTH will permit the seller to transfer some of its tax history (i.e. a portion of its historic profit) with the assets, thus enabling the buyer to carry back decommissioning losses against this transferred tax history. The transferred tax history cannot be adjusted after the transfer. The precise amount of tax history to be transferred by the seller will be a matter of negotiation between the parties, subject to an overall cap equal to the buyer’s estimated share of the decommissioning costs. This estimate is subject to verification by an independent expert and to a “just and reasonable” test. Where multiple fields are being acquired, the tax history transferred to the buyer will be allocated to each field at the time of acquisition and once transferred it will immediately cease to be available to the seller. TTH will not, however, become part of the buyer’s tax history until the acquired field reaches permanent cessation of production and the total decommissioning costs for the buyer’s working interest are greater than the profits accrued on it. The difference between the post-acquisition profits and the total decommissioning cost of the relevant field interest will equal the amount of available TTH.

TTH will apply to licence transfers that receive OGA approval on or after 1 November 2018. It is a measure that is expected to level the playing field between existing operators and new entrants to the UKCS by providing certainty on availability of tax relief for decommissioning costs, encouraging investment in late life assets and maximising economic recovery from a mature basin.