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Decommissioning Security Agreements in the UK – what you need to know

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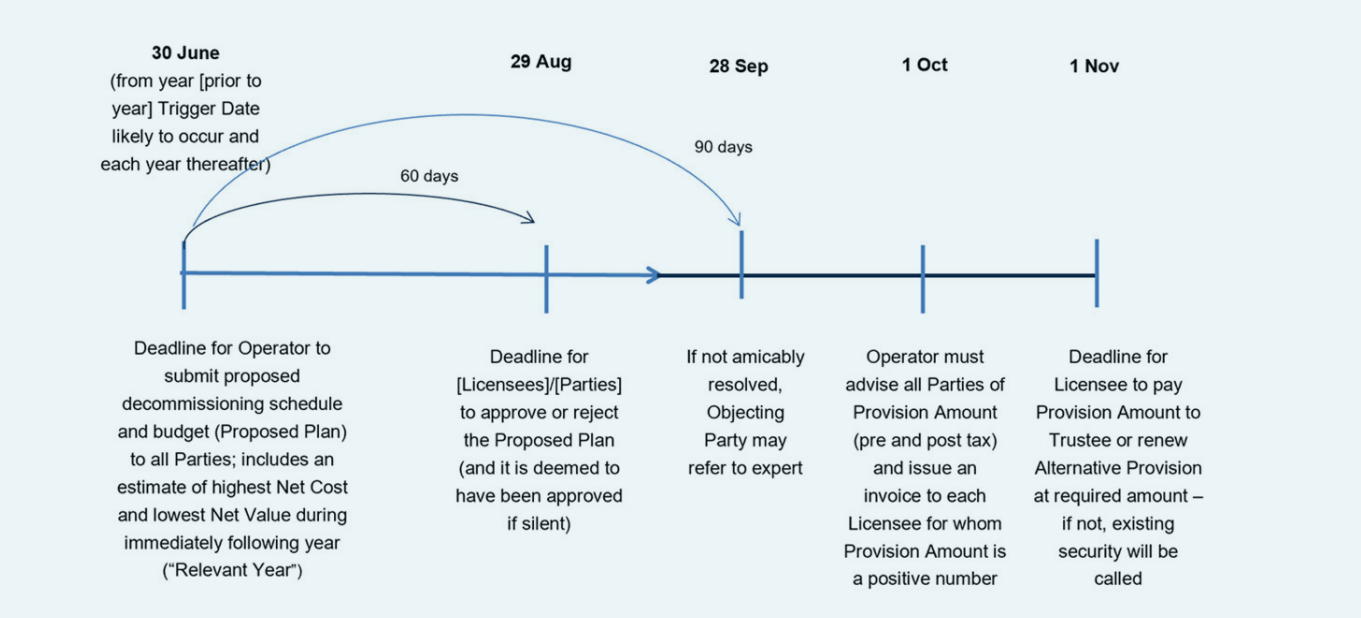
Introduction

Decommissioning of offshore oil and gas installations is a complex and costly process that brings with it many legal, technical, environmental and financial challenges. In the UK, the decommissioning regime is governed by the Petroleum Act 1998 and the associated regulations, which impose a wide range of potential liabilities on current and former owners of offshore infrastructure, as well as their affiliates. To manage these liabilities and provide security for the future costs of decommissioning, it is now industry practice for the parties involved in offshore operations to enter into decommissioning security agreements (**DSAs**).

The most widely used templates for DSAs in the UK are those published by Offshore Energies UK (**OEUK**), the leading representative body for the UK offshore energy industry. The OEUK template DSAs provide a standardised framework for the calculation, provision and management of decommissioning security, and sets out the rights and obligations of the parties in relation to the circumstances when the security must be provided and when and how it may be called upon. The OEUK template DSA has two versions: one for use in relation to fields that are subject to petroleum revenue tax (PRT) (the **PRT DSA**) and another one for all other circumstances (the **Non-PRT DSA**) (collectively referred to here as the **OEUK DSA** for ease of reference).

The first section of this publication is an overview of decommissioning requirements in the UK. The following sections each look in detail at a different aspect of the OEUK DSA, from preparation and approval of the decommissioning plan, calculation and payment of the provision amount, through to the default provisions and the consequences of default. The comments are based on the latest version of the OEUK DSA, which was updated in November 2021 to reflect the transition from LIBOR to SONIA as the reference rate for the calculation of tax relief and bridging finance.

The OEUK DSA provides an indicative timeline for the various steps in the process of calculating and providing the relevant security amounts. Each step is analysed in further detail in the relevant sections of this publication. Visually, the timeline (based on the default dates and periods of time used in the OEUK DSA) is as follows:



Capitalised terms used in this publication which are not otherwise defined have the meaning as given in the OEUK DSA, and clause references are to clauses of the OEUK DSA.

An Overview of Decommissioning Requirements in the uk

Liability generally for decommissioning offshore infrastructure

One of the conditions on which offshore petroleum production licences are granted in the UK is a requirement that, once production comes to an end, all infrastructure that has been installed to produce oil and gas from the licence area must be fully decommissioned. Subject to a few exceptions, that requires its complete removal. That can be a very costly exercise and due to the legislative regime in the UK, various parties are potentially liable for the costs of that decommissioning – this includes the owners of the infrastructure and historic owners, and in each case may even extend to their respective affiliates. Subject to any special arrangements which may have been put in place between the parties concerned, the current owners of the infrastructure at the time of decommissioning will usually pay the costs of such decommissioning in line with their normal joint venture billings – in the same way they will have met the operational costs throughout the life of the asset – and historic owners will not be required to contribute to those costs. However, since the most significant decommissioning costs will arise only after production has ceased, those decommissioning costs will fall due to be paid when there is no (or limited) cash flow from the asset and therefore the risk of a particular owner being able to meet its share of those decommissioning costs is, at least in theory, increased. If that happens, then the liability to meet those costs will fall on the other current owners and potentially also on the historic owners, whose interest in the particular asset may have come to an end many years previously, and who may have only benefited to a very limited extent from the production phase.

Decommissioning Security Agreements

As a result, it is now industry practice in the UK for all of the parties with potential liability to seek security for those costs of decommissioning from the current owners, by means of entering into a DSA – that agreement provides for security for future decommissioning costs to be paid by current owners during the production phase of the asset in respect of the anticipated future decommissioning of offshore installations and infrastructure that will be necessary at the end of their productive life.

OEUK DSA templates

OEUK published the PRT DSA and non-PRT DSA in order to provide for a standardised approach to the provision of security. A combination of the publication of the Decommissioning Relief Deeds in 2013 (see page 17 for an overview of the introduction of the Decommissioning Relief Deed) and the introduction of the Oil & Gas Authority (now North Sea Transition Authority) in 2016 (which has sought to encourage the agreement of DSAs for all existing offshore installations) has resulted in wide-spread use of these agreements across the industry.

All current owners and historic owners (who have been served with section 29 notices[1]) will usually be party to the OEUK DSA, which means that the security posted can then be drawn on by those who may be required to step in in the event that one of the current owners fails to pay its share.

Current owners are generally referred to as "Licensees"; historic owners are "Second Tier Participants" and each group has slightly different rights and obligations in terms of the OEUK DSA – broadly speaking the Licensees have a more active role in the arrangements, with the Second Tier Participants afforded a 'watching brief' along with certain rights so that they can take steps to ensure that the security in place is sufficient to protect against their potential exposure. The OEUK DSA also provides an option for others with potential liability for decommissioning "at-law" to be listed as "Third Tier Participants". If included in the relevant agreement, Third Tier Participants will not be a direct party and therefore have no monitoring rights or involvement in the processes set out in the DSA but will be a beneficiary of the security provided thereunder.

[1] A section 29 notice imposes an obligation on the recipient (pursuant to section 29 of the Petroleum Act 1998) to submit a decommissioning programme on or before such date as the Secretary of State may later specify.

The Starting Point – the Operator Prepares the Proposed Plan

Proposed Plan

The OEUK DSA provides in clause 4 the obligation for the Operator to prepare a plan (the "**Proposed Plan**") containing certain information regarding anticipated decommissioning arrangements and costs, and provide this to the other parties to the DSA by a specific date each year. The 'default' date in the OEUK DSA template is 30 June but parties may elect to move the timing. The obligation on the Operator to prepare a Proposed Plan begins with the year (or the year prior to the year) in which the Operator estimates the Run-Down Period is likely to commence. The Run-Down Period commences, broadly speaking, when the net cost of expected decommissioning exceeds the likely remaining value in the field.

The Proposed Plan shall include a proposed decommissioning schedule and budget, which must include the following information:

- geological or reservoir review of the relevant field;
- estimate of the dates on which decommissioning will begin and finish;
- estimate of the highest Net Cost during the immediately following year (such immediately following year being the "**Relevant Year**");
- estimate of the lowest Net Value during the Relevant Year;
- estimate of the date on which the Trigger Date (being the date on which the Net Value is expected to equal an agreed percentage of the Net Cost, which is often between 100% and 150%) will be reached;
- all other matters relevant to the proper preparation for and management of decommissioning, including but not limited to:
  - decommissioning options;
  - alternative uses for the relevant field property;
  - an assessment of eligibility for derogation from removal obligations; and
  - the salvage value of relevant field property where it cannot be reused.

Assumptions

In order to prepare the Proposed Plan, the Operator is required to apply a set of assumptions in its assessment of the constituent elements of the calculation of Decommissioning Costs which in turn determines the amount of security that is to be posted by the current owners. The key constituent elements in this regard are the Net Cost, Net Value and "TR" - the amount of tax relief for each relevant licensee for the purpose of the security calculation. In the absence of bespoke agreement on particular assumptions by the Parties, the assumptions provided in Appendix 5 of the OEUK DSA are used by the Operator to determine (for example) the rate of inflation, the appropriate currency conversion rates and the future market prices of crude oil and natural gas that are constituent elements of the Operator's calculations.

The assumptions set out in Appendix 5 of the OEUK DSA cover the following:

- currency
- cash flows
- inflation
- no double counting
- tax assumptions
- calculation of TR
- operating assumptions (this includes crude oil and natural gas prices, among others)

The calculation is not merely a mathematical exercise. Some of these require the exercise of judgment or permit an element of discretion, so that the calculation that is carried out by the Operator can be open to challenge by other parties to the DSA, where they disagree with the approach or assumptions that the Operator has adopted.

Approval of (or Objection to) the Proposed Plan

Approval of the Proposed Plan

Once the Proposed Plan has been prepared by the Operator, the parties required to approve the Proposed Plan have an initial 60-day period to do so or to raise any objections. The OEUK DSA template provides for unanimous approval (at least deemed rather than positive endorsement) but allows optionality as to whether the Proposed Plan requires to be approved only by the Licensees, or by all Parties to the DSA.

In the latter case, the approval right includes previous licensees (referred to in the OEUK DSA as Second Tier Participants. Alternatively, the OEUK DSA provides an option where the Second Tier Participants are permitted to provide written representations in response to the Proposed Plan, and to refer those to expert, but where their express approval is not required.

Assumptions

Discussion

If an approving party has any objections to make to the Proposed Plan, it must give a written statement of its objections to the Operator within the 60-day period. Clause 4.3 provides that where objections have been made, all Parties are to meet promptly to discuss those objections and attempt to reach an amicable resolution.

Expert determination

If an amicable resolution is not reached within 90 days of the date the relevant parties are provided with the Proposed Plan, the party objecting to the Proposed Plan is entitled to refer the matter to an expert for determination.

Clause 4.3 provides that the expert shall be required to confirm that those elements of the estimates of Net Cost or Net Value (or, in the case of the PRT DSA, PRT Relief, if applicable) which have been the subject of objections have been made in accordance with the OEUK DSA.

Where the expert does not consider that those estimates are in accordance with the OEUK DSA the expert is to determine the estimates which should have been so made. The Operator must then incorporate the expert's determinations into the Proposed Plan. The Proposed Plan, as adjusted if applicable, is then deemed to be approved and becomes the Decommissioning Plan for the Relevant Year.

Giving notice

Where the DSA requires a Party to give notice, it is important to remember that notices should be served in accordance with the notice provisions. In the OEUK DSA, the notice provisions are contained in clause 13 and provides that notices are to be made in writing to the addresses provided in clause 13 and either (i) delivered personally or (ii) sent by pre-paid registered post, recorded delivery or other fast postal service which provides proof of delivery, or by fax. It is worth noting that the template DSA does not provide for service of notices by email.

Referral to the Expert

Clause 11 sets out the process to be followed in the event a referral to an expert is required.

The first step is for the referring party to serve notice on the other Licensees/Parties requiring the matter to be referred to expert.

Next, the Expert is to be selected. The OEUK DSA sets out two options:

1. the Expert shall be selected by the unanimous vote of the Licensees and any Licensee can nominate an individual for consideration; or
2. each Licensee shall nominate three experts who are ready, willing and able to act. The Licensees will then score the experts according to preference (1 being the lowest preference and 3 being the highest preference) and the expert with the highest score is selected. If there is a tie, lots are to be drawn amongst the tied experts.

Where the relevant Parties have not agreed the identity of the Expert to be appointed, the OEUK DSA includes provision for requesting that an agreed organisation appoint an individual to act as Expert. In early DSAs, parties would often agree to apply to the Energy Institute to appoint an Expert in such circumstances but we understand that the Energy Institute no longer provides this service – it will be necessary for the parties entering into a DSA to identify and agree a suitable appointing body for their agreement.

Following acceptance by the Expert of the appointment, the timetable for a decision under the OEUK DSA is as follows:

Action	Date
Expert to notify the Operator of his preliminary decision	Within 30 Business Days of the date of appointment
Expert can extend period for providing preliminary decision	By up to 10 Business Days (so that in total the Expert may have up to 40 Business Days to provide his preliminary decision)
Parties can make representations on preliminary decision	Within 10 Business Days from the issue of the preliminary decision by the Operator to the Parties (the Operator is required to do so "promptly" on receipt of the preliminary decision from the Expert)
Expert to consider representations and make final decision	Within 30 days of notification of his preliminary decision to the Operator

Under the OEUK DSA, the final decision of the Expert is binding on all the Parties except in the case of fraud or manifest error.

Unless a more detailed process is provided for in the DSA, typically once the Expert is appointed they will set out a proposal as to how the matter is to be conducted including a timetable. This might involve meetings with the Expert and might include Parties providing the Expert with written or oral submissions.

Some Pros & Cons of Expert Determination

There are a number of factors that may be relevant to take into account when considering whether to provide for disputes to be determined by an expert rather than proceeding with litigation or another alternative dispute resolution method.

For example:

Pros:

— In appointing an expert, the parties can select their preferred individual to resolve their dispute, who they consider has particular skills and expertise to deal with the dispute.

— The dispute and determination remain confidential, unlike in court proceedings which will usually be a matter for public record.

— Expert determination tends to be less expensive than proceeding through the courts or arbitration.

— Typically expert determination results in a binding resolution of the dispute in a much quicker time than proceeding with litigation or arbitration. Following the OEUK DSA timeline, the Parties can expect to reach a resolution within around three months (40 Business Days for a preliminary decision with a further 30 days for the final decision).

Cons:

— The ability to appeal or challenge an expert decision is very limited due to the binding nature of the expert's determination. Under the OEUK DSA, the Expert decision is binding except in cases of fraud or manifest error. However, such an appeal may be difficult, particularly where the Expert has not provided any reasoning for his determination.

— If it is necessary to enforce an Expert's decision, generally speaking, further court action or arbitration proceedings will be required.

— The Expert's determination will likely only apply to the Proposed Plan for a particular Relevant Year – it will not have binding effect for future years.

The Decommissioning Plan

If no objections are received within the 60-day period, the Proposed Plan is deemed to be approved and becomes the Decommissioning Plan for the Relevant Year. Under the suggested dates in the OEUK DSA, the Proposed Plan is to be submitted by 30 June in the year prior to the Relevant Year, meaning if objections are not received by 29 August in that year, the Proposed Plan becomes the Decommissioning Plan for the Relevant Year.

Calculation and Payment of Security for Licensee's Share of Decommissioning Costs

Against a backdrop of assets nearing their cessation of production dates and challenging economic conditions, such as inflation increases in recent years, many Decommissioning Plans have led to a requirement for licensees to provide increased amounts in security.

The proper calculation of those amounts, and the specific details of the security that may be provided has therefore seen much greater focus in recent years than was perhaps previously the case.

When must security be provided?

Licensees' obligations to pay their respective shares of the estimated costs of decommissioning (i.e. the relevant Licensee's Provision Amount) or make alternative provision (i.e. place a letter of credit, bond, guarantee or other agreed form of quasi-security into trust) for those amounts are triggered by the Operator advising the Licensees of the Provision Amounts and issuing a Provision Invoice to each Licensee whose Provision Amount is a positive number. These obligations are generally contained in clauses 6 and 7 of the OEUK DSA – the timeline that is suggested by the OEUK DSA requires the Provision Invoices to be issued by no later than 1 October in any Year prior to a Relevant Year (i.e. the calendar year to which the Decommissioning Plan applies), and security to be provided by 1 November in that Year, although this is commonly amended to provide for payment by 1 December in the Year prior to the Relevant Year.

How much security must be provided - calculation of the Provision Amount

Clause 6 provides that the Operator calculates the Provision Amounts on the Pre-Tax Basis and the Post-Tax Basis. The Post-Tax Basis is used because Licensees are, under current legislation and as a result of the Decommissioning Relief Deed, expected to benefit from tax relief on decommissioning spending (and are therefore generally comfortable with each other providing cash or security on a post-tax basis) (see section 6 of this publication for an overview of the Decommissioning Relief Deed). However, the Pre-Tax Basis is used also because there is the potential for this tax position to change (and clause 2 of the OEUK DSA provides for adverse tax events).

The OEUK DSA sets out the calculations by which the Provision Amount is to be calculated by reference to various formulae:

$$\textbf{Pre-Tax Provision Amount} = (X \times Y)\ [-Z] - F$$

$$\textbf{[Non-PRT] Post-Tax Provision Amount} = (X \times Y) - TR + R_{Bridge}((9/12)TR_{RFCT\&SC})\ [-Z] - F$$

$$\textbf{[PRT] Post-Tax Provision Amount} = (X \times Y) - TR + R_{Bridge}((8/12)TR_{PRT}+(9/12)TR_{RFCT\&SC})\ [-Z] - F$$

— **X** is the Licensee's share of the decommissioning costs as provided in the Decommissioning Plan or Proposed Plan for the Relevant Year.

— **Y** is the risk (i.e. contingency) factor. This factor is agreed in the DSA itself and is usually a number greater than one. The OEUK DSA includes optional language allowing two risk factors to be agreed, with one applying until approval of the Statutory Decommissioning Programme for the relevant field (the Initial Run-Down Period) and the other applying from approval of that programme until 12 months after its completion (the Later Run-Down Period). Parties will tend to agree a lower risk factor for the Later Run-Down Period on the basis that once there is an approved Statutory Decommissioning Programme there will be more certainty over the decommissioning work that will have to be performed and the costs of doing so.

— **Z** is the Licensee's share of the estimated Net Value as provided in the Decommissioning Plan or Proposed Plan for the Relevant Year. As provided in the OEUK DSA formulae above, the question of whether to deduct "Z" from the

calculation will have been considered by the parties at the time that the DSA is entered into and addresses whether the value of a party's interest in the relevant field can be taken into account as (effectively) part of their security.

— **F** is the amount of any existing provision already provided by the Licensee. The calculation therefore takes account of any cash or alternative security already held by the Trustee from that Licensee which will not expire at the end of the current Relevant Year and so will continue to apply throughout the next Relevant Year, such as evergreen guarantees. Where there is such continuing security, a Licensee will only be required to post a 'top up' amount of additional security.

— **TR** is the amount of tax relief for each Licensee. TR is calculated only in relation to that part of the estimated costs for which there is (i) any reduction in Tax liability or any Tax repayment which results (or is expected to result) from incurring Decommissioning Expenditure, or (ii) a payment which will become due pursuant to a Decommissioning Relief Deed. It will be bespoke for each Licensee, rather than calculated at a joint venture level.

— **$TR_{RFCT\&SC}$ / TR_{PRT}** is the allowed Ring Fence Corporation Tax and Supplementary Charge Relief or PRT Relief calculated in accordance with paragraph 6 of Appendix 5 of the OEUK DSA. There are two options provided in paragraph 6 of Appendix 5 for calculating PRT Relief: Option A1 is a precise calculation based on the PRT Certificates issued by HMRC and Option A2 is a calculation which assumes a standard rate for all Licensees, Option A1 is the 'default' option and so will be used unless the parties unanimously agree to use Option A2. Each of $TR_{RFCT\&SC}$ / TR_{PRT} are multiplied by a factor intended to reflect the average period which is expected to accrue between the expenditure being incurred and the receipt of the relief payment from Government, which in the case of $TR_{RFCT\&SC}$ is nine months and in the case of TR_{PRT} is eight months.

— **RBridge** is an annual rate of bridging finance equal to SONIA Compounded in Arrears plus an agreed percentage points figure. The use of SONIA Compounded in Arrears was adopted by the OEUK DSA in November 2021, prior to which LIBOR was used. DSAs entered into prior to November 2021 therefore tended to use LIBOR and may not have been updated to SONIA Compounded in Arrears.

All parties to the DSA will have a real interest in scrutinising the Operator's calculation carefully. Licensees will want to ensure they are not required to post a greater amount of security than is necessary. Second Tier Participants will be keen to ensure that the amount of security that is provided is adequate to cover the costs of decommissioning, as that is the fund on which the Second Tier Participants will draw if the Licensees fail to meet their obligations in this regard.

Small changes in approach can have significant consequences to the total estimate that is produced, and may be debated between the parties where (for example) there is scope for the exercise of discretion in the calculation or where current economic conditions may impact the calculation in a way that may not have been anticipated when the DSA was entered into. For example, OEUK (in April 2023) issued guidance relating to inflation and discounting methodologies in Net Value and Net Cost calculations. This guidance was issued in response to significant levels of inflation and higher interest rates in the UK since 2021 and in recognition that the assumptions applied in the OEUK DSA regarding inflation and discounting were backward-looking and "*unlikely to be representative of credible long-run trends*". In other words, there was a feeling within some parts of the industry that the OEUK DSA inflation and discounting assumptions would result in potentially volatile Provision Amounts that could, at times, over- or under-estimate the likely actual costs of decommissioning, resulting in fields being 'over-secured' as a result of high inflation around the relevant time of calculation or 'under-secured' as a result of low inflation around the relevant time of calculation. The OEUK guidance therefore includes recommended revisions to the OEUK DSA that aligns the basis of revenue and cost inflation, and discounting, to be based on a forward-looking Monetary Policy Committee forecast / Bank of England target basis.

Payment of Provision Amount

Each Licensee whose Provision Amount is a positive number is required to pay its Provision Invoice in full by no later than the due date for that invoice – again, under the OEUK DSA template, the suggested date of issue of the Provision Invoice is 1 October in the year prior to the Relevant Year and payment of the Provision Amount (or Alternative Provision) is due by 1 November in that Year, however parties often amend this latter date to 1 December.

If, however, the Provision Amount is a smaller positive amount than the immediately previous Provision Amount, no further payment is required to be paid and there is a mechanism for surplus security to be returned to the relevant Licensee.

Cash payment

The "default" requirement under the OEUK DSA template is for each Licensee to make a cash payment in the full amount of their Provision Amount which is held by the Trustee under the Trust Deed executed by the relevant Licensee.

Alternative Provision

As an alternative to making cash payment of the Provision Amount, Licensees are entitled to make an Alternative Provision to the relevant Trustee.

The OEUK DSA suggests the following ways (whether alone or as a combination):

1. **Irrevocable letter(s) of credit** issued by the UK branch or lending office of a Bank (or consortium of banks) which are Qualifying Sureties. Parts 1 and 2 of Appendix 3 of the OEUK DSA contain suggested forms of letters of credit. Their key features are:

   a. the Bank agreeing to pay, up to a maximum amount of the relevant Provision Amount, the amount demanded in any demand notice;

   b. the demand notice should not require the Trustee to prove any failure by the Licensee to pay under the DSA; and

   c. incorporation of appropriate industry rules relating to letters of credit (such as the ICC Uniform Customs and Practice for Documentary Credits).

2. **Irrevocable, unconditional on demand payment bond from the UK branch of a Qualifying** Surety (other than the Licensee or an Affiliate) accompanied by Counsel's Opinion (i.e. a legal opinion from an independent law firm or legal practitioner in the form set out in Appendix 6). The OEUK DSA does not include a suggested form of bond (whether issued by the Licensee itself or an Affiliate (see 3 below) or the UK branch of a third party Qualifying Surety). Common key features of a DSA bond include:

   a. the issuer irrevocably and unconditionally agreeing to pay on receipt of a valid demand notice the amount demanded in the demand notice up to a maximum amount of the relevant Provision Amount;

   b. the demand notice should not require the Trustee to prove any failure by the Licensee to pay under the DSA; and

   c. incorporation of appropriate industry rules relating to bonds (such as the ICC Uniform Rules for Demand Guarantees).

3. **Irrevocable, unconditional on demand payment bond from an affiliate of the Licensee or by the Licensee itself** which is a Qualifying Surety and accompanied by Counsel's Opinion. The common key features of a bond are the same as those summarised at 2 above; and

4. **Guarantee from the ultimate holding company / an Affiliate of the Licensee** which is a Qualifying Surety and accompanied by Counsel's Opinion. The form of guarantee should be agreed between the parties – the OEUK DSA does not contain a suggested form. Common key features of a DSA guarantee include:

   a. the guarantor guaranteeing for the benefit of the Trustee the payment obligations of the Licensee under the DSA;

   b. a form of demand that does not require the Trustee to prove any failure by the Licensee to pay under the DSA; and

   c. a robust list of events that will not discharge the liability of the guarantor.

In our experience, all of these forms of Alternative Provision are routinely included as options in a DSA used in respect of the UK Continental Shelf, and most Licensees choose to make Alternative Provision in respect of their Provision Amount, as it means that it is not necessary to tie up potentially significant amounts of funds as security. Notwithstanding that, it is sometimes convenient for other reasons to pay a particular Provision Invoice in cash. For example, parties acquiring an interest in the field (whether as part of an asset acquisition or a corporate acquisition) to which an existing DSA relates sometimes choose to pay the then current Provision Invoice in cash to simplify completion of the acquisition (and to avoid paying cash for cash as part of the acquisition). The acquiring party may then choose to make Alternative Provision for future Relevant Years and have returned to it the cash previously paid to the Trustee.

The OEUK DSA also allows such other forms of provision as may be agreed between the parties from time to time. An insurance bond is one such other form of provision to which parties are often willing to agree.

A "Qualifying Surety" is a Bank (or, if the parties choose to include optional wording, a company or corporation) which has a minimum corporate credit rating agreed between the parties. The OEUK DSA includes as optional wording, a corporate credit rating of at least AA- from Standard & Poor's or Aa3 from Moody's. These ratings are no longer widely used and are generally viewed by the market as being unnecessarily high following the general downward trend of credit ratings over the past ten to fifteen years. However, these are only suggestions and parties often have their own 'corporate policy' minimum acceptable ratings. We more commonly see A- (Standard & Poor's) and A3 (Moody's).

If the parties agree to an insurance bond being an acceptable form of Alternative Provision, it is usually necessary to amend this definition to allow insurance companies to be Qualifying Sureties. The insurance industry adopts specific ratings (rather than corporate credit ratings) that also need to be reflected in the Qualifying Surety definition.

Parties sometimes agree to add flexibility to the Alternative Provision clauses by, for example:

— only requiring Counsel's Opinion where the issuer of the relevant Alternative Provision is not incorporated in the United Kingdom; and

— allowing any Licensee at any point during a Relevant Year to change the method of Alternative Provision by which it provides the Provision Amount, or to pay the Provision Amount in cash.

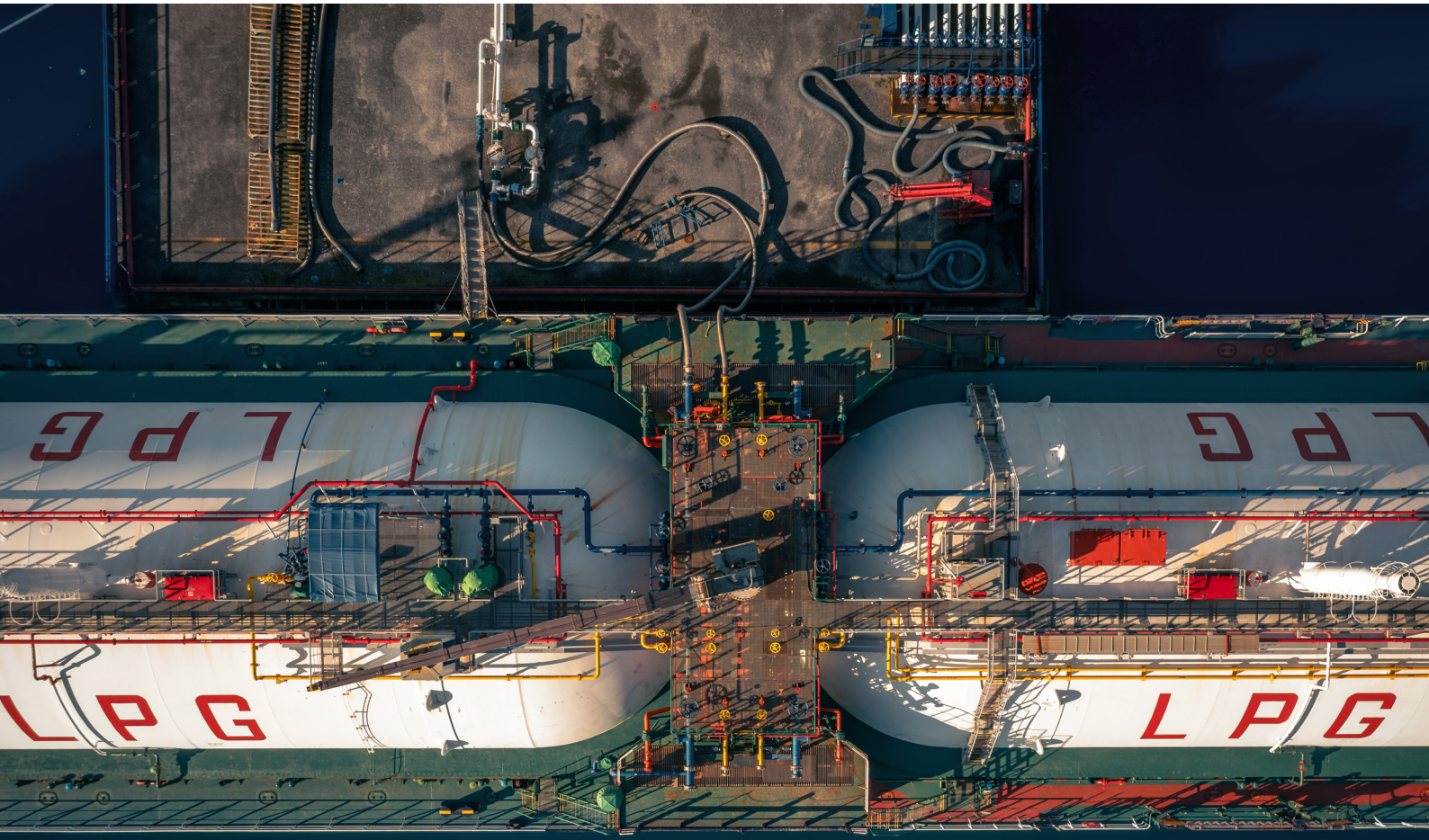
Provision Invoice / Provision Amount when Decommissioning Plan is not approved

The Proposed Plan approval and objections process timeline and the fixed date for issuing and paying (or providing Alternative Provision for) the Provision Invoices creates a risk that the Decommissioning Plan is not approved by the time the Operator is obliged to issue Provision Invoices.

The OEUK DSA caters for this situation by providing that where the Decommissioning Plan has yet to be approved or deemed approved the Provision Invoice is issued by the Operator based on its Proposed Plan for the Relevant Year. Where the Provision Invoice has been issued based on the Operator's Proposed Plan and the Provision Amount as calculated under the Decommissioning Plan is greater than that calculated under the Proposed Plan, the Operator issues a supplemental Provision Invoice for the balance at the point where the Decommissioning Plan for the Relevant Year is determined (by Expert if the parties have been unable to agree).

The Licensee then either: (i) makes payment to the Trustee of the balance to be held under the Trust Deed, or (ii) provides Alternative Provision. Such supplemental Provision Invoices are to be paid within 15 Business Days.

Where the Provision Invoice has been issued based on the Operator's Proposed Plan and the Provision Amount as calculated under the Decommissioning Plan is less than that calculated under the Proposed Plan, the Operator must serve a Type VI Notice on the Trustee requiring the Trustee to refund the difference to each Licensee (if the relevant Provision Invoice was paid in cash), or return the previous Alternative Provision to such Licensee (or such other nominated person) for cancellation on receipt of the reduced Alternative Provision (if Alternative Provision was made in respect of the relevant Provision Invoice and reduced Alternative Provision is provided).



What Happens if Security is not Provided – Default Provisions

It is crucial to the operation of the arrangements set out in DSAs that parties post the required security within the timelines set out in the DSA as well as comply with their other obligations under the DSA. To enforce this requirement (and in common with many types of contracts), DSAs will include default provisions to cover various circumstances which may impact on the amount of availability of the security provided under the contract.

The consequences of default when such circumstances arise differ depending on the specific terms of a particular DSA, so each contract should be considered carefully on its own terms.

Default under the OEUK DSA by a Licensee

Under the OEUK DSA, a default event (a "**Default**") is described in clause 8.1 as arising when a Licensee:

i. fails to comply with particular provisions in respect of the Provisional Amount, Additional Amount or Alternative Provision;

ii. fails to pay an invoice issued under the DSA when it falls due;

iii. receives a notice of default from the Operator under the joint operating agreement ("**JOA**") for the relevant field(s);

iv. becomes insolvent;

v. fails to pay the relevant Trustee the Provision Amount or provide replacement Alternative Provision within a certain time when requested by the Operator in circumstances where the issuer of any Alternative Provision becomes insolvent;

vi. fails to pay the relevant Trustee the Provision Amount or provide replacement Alternative Provision within a certain time when requested by the Operator in circumstances where the issuer of any Alternative Provision ceases to be a Qualifying Surety;

vii. fails to pay the relevant Trustee the Provision Amount or provide replacement Alternative Provision within a certain time when requested by the Operator in circumstances where the issuer of any Alternative Provision, in the case of a guarantee ceases to be the ultimate holding company/ Affiliate of the Licensee;

viii. fails to enter into a Trust Deed within a certain time following notice from the Operator;

ix. fails to renew or replace any Alternative Provision as required under the OEUK DSA or to make payment to the relevant Trustee within a certain time of notice from the Operator

x. (optional under the OEUK DSA) fails to make payment to the relevant Trustee where, if applicable, there has been a material adverse change in any fact or matter on which Counsel's Opinion expressly relies (in the reasonable opinion of the Operator); and

xi. being a sole Licensee, fails to carry out its obligations to submit and/or undertake any part of a Statutory Decommissioning Programme within any time limit stipulated by the Secretary of State pursuant to the Petroleum Act 1998.

The focus is on ensuring that the full amount of security is posted in a timely manner and will ultimately be available to meet decommissioning costs if required, in accordance with the terms of the DSA. A failure to do so may arise not only where a Licensee fails to make its own security posting, but also where the security provided becomes defective for any reason (for example, where difficulties arise with the issuer of any Alternative Provision (which may be in the form of a parent company guarantee, bond or letter of credit)). The process for addressing a Default is intended to allow the non-defaulting parties to step in quickly (in some instances, having allowed the defaulting party a period to remedy the failing) to ensure that the Default is remedied or that alternative measures are put in place.

Default process

Where a Default occurs, clause 8.2 provides that each Licensee undertakes to promptly notify the Operator and Trustee "*as soon as it becomes aware*" of any Default. Responsibility for identifying and taking steps to address any failure falling within the list set out in clause 8.1 is therefore not only the responsibility of the Operator but rather of all of the parties to the DSA.

When a Default is identified by or notified to the Operator, the Operator is required to serve a Default Notice on the Trustee to take steps to realise any Authorised Investments and/or any Alternative Provision made by or relating to the Licensee – this has the consequence of converting any Alternative Provision to cash, to be held on trust by the Trustee.

Optional wording is then contained in clause 8.3, providing mechanisms by which the non-defaulting parties under the DSA are then required to meet any shortfall in the security amount posted by or held for the defaulting Licensee (whether that shortfall arises because of a failure by the defaulting Licensee to post security as required, or because of issues that have arisen with any Alternative Provision of that defaulting Licensee). Under these optional provisions, the Defaulting Licensee can remedy the Default at any time prior to the forfeiture or transfer of its License Interest (as per the default provisions set out in the JOA) by meeting in full all debts that have arisen as a result of the Default, including posting such security as is required and paying interest to the non-defaulting parties that have 'stepped in' to meet the outstanding amounts in the interim.

Where the Default is not remedied and the Defaulting Licensee's License Interest is forfeited/transferred under the JOA, clause 8.4 sets out a process by which the Defaulting Licensee's security amount as held by the Trustee is allocated to the trust accounts of each of the non-defaulting Licensees, in proportion to their interest share, and the non-defaulting Licensees are required to make up any shortfall. In that instance, the Defaulting Licensee is then indemnified by the non-defaulting Licensees in relation to decommissioning costs up to the amount that is transferred to that non-defaulting Licensee's trust from the Defaulting Licensee's trust. If there is a shortfall when it comes to the actual costs of decommissioning, the Defaulting Licensee is required to meet its share of costs over and above the amount secured from its trust – although in practice, depending on the circumstances of the default and subsequent forfeiture, there must be a reasonable likelihood that it will not be able to meet any claim for such a shortfall.

Default under the OEUK DSA by the Operator

The OEUK DSA also sets out provisions covering circumstances where it is the Operator that is found to be in Default. Under clause 8.5, if an Operator fails to carry out any of its obligations under the OEUK DSA in any material respect, the failure shall constitute a breach under the JOA justifying removal of the Operator. In that instance, one of the other Licensees may take over the obligations of the Operator, or in the event the Operator is the sole Licensee, the Second Tier Participants may be permitted to appoint an Operator in the circumstances.

In extreme circumstances, clause 8.6 provides for circumstances where the Operator fails to carry out its obligations under the OEUK DSA, the Operator is the sole Licensee, there are no Second Tier Participants (or none willing to take on the role of Operator), and another entity is the recipient of a section 29 notice (i.e. a notice from the Secretary of State confirming that such entity has a duty to carry out a Statutory Decommissioning Programme). In that (likely rare) scenario then a novation may be entered under which the entity with the decommissioning obligation accepts and assumes all of the rights and obligations of the Operator.

Consequences of Default Provisions

The default provisions in the OEUK DSA are designed to ensure that each of the parties posts each year the full amount of security that has been calculated in accordance with the DSA as being required such that all stakeholders (including those not directly party to the DSA itself) obtain comfort that relevant decommissioning costs will be met at the relevant time. The sums likely to be involved make it important that non-defaulting Licensees are able to move quickly to protect their interests and ensure that adequate decommissioning security is in place.

A failure to post the required security therefore has very serious potential consequences, both under the DSA and the JOA.

— A default under the relevant JOA is a cross-default under the DSA, reflecting the close interaction of the two agreements. In some ways, many of these events of default can be considered as early warning signs – i.e. if a party is in default of its payment obligations under the JOA, it may be indicative that there are wider solvency issues and therefore there may be a need to take steps to protect the security.

— Underlining the importance of ensuring adequate decommissioning security is in place, a Default under the DSA will be a cross-default under the JOA. Subject to the precise terms of the specific contracts, that means that a party which fails to post security in accordance with the DSA likely risks also losing its rights to participate in the management of the underlying asset (for example, being excluded from operating committee meetings and denied any information pertaining to ongoing operations) and ultimately its participating interest share in the operations.

For parties entering into the OEUK DSA, it is worth considering in practical terms how the default provisions under the OEUK DSA play out in practice when working alongside the provisions under the JOA, particularly those relating to forfeiture/transfer of interest, to ensure that the necessary processes are streamlined and complimentary, and do not create a greater burden on the non-defaulting Licensees than is necessary to achieve the overall aim.

UK Decommissioning Relief Deeds – a World First!

The publication on 7 November 2013 by HM Treasury of the final form of Decommissioning Relief Deeds marked a milestone in a 30 month collaboration between government and industry to provide long-term certainty on decommissioning tax relief.

Under UK legislation, owners of offshore infrastructure at the end of its useful life are jointly and severally liable to decommission it. If the owners fail to do so, a wide range of people including former owners are also potentially liable to be brought back to pay for decommissioning. As a result, co-venturers in oil fields often enter into decommissioning security agreements (DSAs), under which each owner provides security to the others against the risk of defaulting on its decommissioning obligations. Oil companies selling interests in fields will also require such security from those purchasing their interest. Security is usually provided in the form of a letter of credit from a bank, and the bank will often require collateral from the party providing the security. This security therefore ties up a lot of capital which could be more usefully employed.

Tax relief is currently available for decommissioning costs when they are incurred but this relief could be withdrawn or amended at any time, and requires a party to have sufficient taxable profits against which to set the reliefs. Owners deciding whether to invest in a field where decommissioning may not happen for another twenty years will make cautious assumptions about the availability of relief, as they will when requiring security from their partners or from purchasers. DSAs typically therefore require security to be calculated "gross", without any allowance for tax reliefs. This significantly increases (by a factor of 4 in some cases) the funds tied up in security which would otherwise have been available to invest, and prices some parties out of the market for assets.

Over the past two and a half years Oil & Gas UK has been working with HM Treasury to find a means of addressing this issue. The novel solution proposed by industry was the use of a contract which would be available to any party potentially liable for decommissioning in which the Government effectively guarantees the present rates of tax relief. Under these contracts, if the tax relief regime changed, the Government would make a compensating payment to the affected companies. However, if the tax relief regime remains unchanged, then except in the rare event of default (where minimum rates of tax relief are available to unrelated parties brought in to remedy the default) the Exchequer will pay no more in tax relief than it is expecting to pay today. The advantage of the contractual solution is that it is much harder for the Government to unilaterally alter the terms of a contract than to change tax rules. In a speech at Offshore Europe in September the Chancellor of the Exchequer, George Osborne, stated: "Never before has any government entered into legally binding contracts with individual companies to guarantee the tax relief they can expect decades into the future. No other place in the world provides such a guarantee."

The Government has now introduced the necessary authorising legislation, and amendments to the tax code, to facilitate the contracts in the Finance Act 2013. The contracts, known as Decommissioning Relief Deeds (DRDs), are also now available to eligible companies and the first DRDs were signed last month. The effect of this change will be to encourage investment by existing owners of assets, increase asset trades and free up capital currently put aside to provide security, thereby extending the productive life of many fields – all at no cost to the Exchequer. Oil & Gas UK's analysis suggests that decommissioning certainty will unlock new investment of about £40 billion, generate an additional 1.7 billion barrels of oil and gas and, over the next five years alone, the Exchequer could receive an extra £1 billion in tax revenue.

To achieve the full extent of these benefits, now the Government has put in place the statutory authority and begun to issue the new contracts, the final piece of the tapestry is for both existing and future DSAs to be amended to provide for security to be given net of tax relief. Oil & Gas UK has published suggested revised versions of its template DSA to take account of the introduction of DRDs. Oil companies are now beginning to address the significant task of amending existing DSAs (many of which predate the industry standard and are in many and various forms) to reflect the new guarantee.

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