Briefing

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Building a new regulatory regime for the North Sea: the MER UK Strategy



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On 5 February, DECC published its response to its consultation on its draft strategy for maximising economic recover of the UK's remaining offshore oil and gas (the **Strategy**)[1] together with a final version of the Strategy. On 18 March the final version was brought into force.

The Strategy is a fundamental component of the UK's new oil and gas regulatory regime in the UK, which will be put in place when the Energy Bill is finally enacted later this year. It will be legally binding on the industry's new regulator, the Oil and Gas Authority (**OGA**), offshore licence holders and operators, and developers, owners and operators of upstream oil and gas infrastructure (**relevant persons**). The OGA has a suite of enforcement powers to ensure compliance with the Strategy. It is therefore vital for the industry that their obligations under Strategy are clear and that the manner in which they will be enforced is predictable, not least because investor confidence could be severely damaged if this is not the case.

This note outlines the main elements of the Strategy and then comments on the importance of the OGA developing clear policies on its approach to the enforcement of the Strategy.

The Strategy

The Strategy has four components:

- The **central obligation**, which is a high level obligation of general application.
- **Supporting obligations**, which set out how the central obligation applies in specific circumstances.
- **Required actions and behaviours**, which relevant persons are expected to take and observe when complying on the central and supporting obligations.
- **Safeguards**, to which the central obligation, supporting obligations and required actions and behaviours are subject.

Central obligation

The central obligation requires relevant persons to take the steps necessary to secure the maximum value of economically recoverable petroleum from UK waters.

In effect, this is a restatement of the "principal objective" under the Petroleum Act 1998, which is to maximise economic recovery of UK petroleum. By making it the central obligation in the Strategy, the principal objective will become legally binding on relevant persons, as relevant persons have a legal obligation under the Petroleum Act is to comply with the Strategy.

"Economically recoverable" is a key concept in the Strategy and is discussed further below.

Supporting obligations

The supporting obligations cover the following areas:

- Exploration
- Development
- Asset stewardship
- Technology
- Decommissioning

[1]DECC's consultation response document can be obtained here. The document contains a revised draft of the Strategy.

Exploration
Licence holders are required to undertake exploration activities within their licence area in the manner which is optimal for maximising the value of economically recoverable petroleum from that area. They are also required to undertake exploration activities in relation to matters outside their licence area in the manner set out in any relevant plan produced by the OGA.[2]

The Strategy provides no indication of the sort of exploration activities outside of a licence area that a licence holder may be required to carry out. It seems likely that the OGA's plans in this context will be for collaborative regional approaches to exploration programmes to minimise cost, for example for multi-licence seismic. The satisfactory commercial return and third party contribution safeguards (on which see "Safeguards" below) are likely to be important here to ensure that a licence holder is not required to provide funding for an activity which is likely to benefit a third party disproportionately.

The exploration supporting obligations also provide that a licence holder cannot relinquish a licence without having completed the agreed work programme. This does not add anything to the terms of existing licences. There is an acknowledgement that there may be an agreement by the OGA to allow a licensee to dispense with a work programme on the particular licence if it carries out an equivalent work programme elsewhere which enables the central obligation to be met. This largely reflects the historic approach of DECC (and more recently the OGA).

Development
Infrastructure is required to be planned in a way which results in the optimal configuration for maximising the value of economic recoverable petroleum from the region in which it is located. The extent to which proposed new infrastructure could be used by third parties who have interest in the region, and whether any existing infrastructure already in existence could be used as an alternative, must be considered in the planning phase.

Asset stewardship
Owners and operators of infrastructure must ensure that it is maintained and operated in such a way as to achieve optimum levels of performance (including production and cost efficiency) for the duration of production and that facilitates recovery of the maximum value of economically recoverable petroleum from the region in which it is situated. This includes allowing access to infrastructure on fair and reasonable terms and, importantly, prioritising access which maximises the value of economically recoverable petroleum.

DECC have acknowledged that the latter requirement is inconsistent with its current guidance on third party access rights under the Energy Act 2011. That guidance provides that, where there are capacity constraints, an infrastructure owner can prioritise its own production over the production of third parties. DECC intend to amend their guidance in this regard to bring it into line with the Strategy. This is one of the areas where difficult issues may arise. It is possible to anticipate, for example, that an infrastructure owner who has developed a producing field may be required under the Strategy to reduce production from that field (and thus the return from the investment in developing the field) in order to allow access by a third party.

Technology
Relevant persons must ensure that technology is deployed to optimum effect and in accordance with plans produced by the OGA. Regard must be had to risks and uncertainties associated with technologies and the potential benefits to the UK of the development and deployment of them.

Decommissioning
Opportunities for the continued use of infrastructure must be considered before it is decommissioned. Decommissioning must be implemented in a cost effective way that does not prejudice the maximising of the recovery of economically recoverable petroleum. Again, there is reference to the OGA identifying particular pieces of infrastructure the decommissioning of which would prejudice the maximising of economically recoverable petroleum in one of its plans.

Required actions and behaviours

There is a general obligation to collaborate with other persons in order to comply with the Strategy.

Where a relevant person is not able or has decided not to ensure the recovery of the maximum value of economically recoverable petroleum from a licence or infrastructure for financial reasons, it will be required seek investment to allow it to do so, or, if that investment is not available, to divest the relevant assets. The relevant person will also be required to divest where such recovery cannot be made for operational or other reasons. The terms of any divestment must not be unreasonable and the relevant person cannot demand compensation in excess of fair market value. If the relevant person has not divested after a reasonable period of time, it will be required to relinquish the relevant licences.

Safeguards

There are five safeguards:

- No conduct can be required which would be prohibited under any legislation or the common law (including the OGA's common law obligation to act reasonably).

[2]See "OGA plans" below for a further discussion of these plans.

- No person can be required to invest or fund activity where they will not make a "satisfactory expected commercial return" from it. This is a key concept in the Strategy - see "Key concepts" below for further discussion.
- Where any relevant person has delayed or decided not to undertake investment or activity because it will not receive a satisfactory commercial return.
- Where a relevant person is required to invest or fund an activity that will benefit a third party, that relevant person can require a financial contribution from the third party in an amount which is fair and reasonable.
- The assessment of what is fair and reasonable must take into account all the circumstances and, specifically, the importance of realising the third party's assets to meet the central obligation.
- No investment, funding or other conduct will be required where the benefits of it to the UK are outweighed by the damage to investor confidence in exploration / production projects offshore UK that imposing the requirement will cause. This is an important safeguard. It only requires a balance to be struck between benefit to the UK and investor confidence, so investor confidence is not necessarily an overriding safeguard.

OGA plans

As will be seen from the above discussion, the Strategy anticipates that the OGA will produce plans in certain specific areas. The Strategy, however, gives the OGA the general ability to develop plans which set out their view on how the obligations of relevant persons under the Strategy should be met. These plans might be specific to a particular region or group of relevant persons or may apply more generally. It is not entirely clear whether the regional development plans that the OGA anticipates will be produced will be "plans" for the purposes of the Strategy.

The OGA is required to consult with relevant persons when producing a plan. Relevant persons will need to aware of any plans that may affect them, as they are required to consult with the OGA where they are proposing to undertake any activity which is inconsistent with a plan.

Key concepts

As will be seen from the summary above, there are two key concepts to the Strategy:

- "Economically recoverable": this means resources which could be recovered at an expected (pre-tax) market value greater than the expected (pre-tax) resource cost of their extraction. For these purposes costs include capex and opex but not sunk costs and other costs which do not reflect the current use of resources.
- "Satisfactory expected commercial return": this is an expected (post-tax) return that is reasonable having regard to the relevant circumstances, including the risks and nature of the investment or other funding, and the particular circumstances affecting the relevant person. Importantly, the Strategy provides that this is not necessarily a return commensurate with real corporate return on that person's portfolio of investments.

Importantly, satisfactory expected commercial return is post-tax return whereas economically recoverable refers to pre-tax value. This inconsistency was raised as part of the consultation responses. DECC's response was that it would be inappropriate for the value of economically recoverable petroleum to be assessed on a post-tax basis, because the aim of the Strategy is to maximise the net benefit to the UK as a whole of the UK's offshore resources. The share of the resources which are allocated to the UK government through the UK's fiscal regime, should not, therefore, be a relevant consideration. DECC's view was that the commercial return safeguard is adequate to protect investors in these circumstances.

Regulatory approach

A key area of potential concern for relevant persons, from a regulatory risk perspective, lies in the legally binding nature of the Strategy – in particular in the enforcement powers conferred on the OGA in relation to the Strategy.

As mentioned above, relevant persons will be legally obliged under the Petroleum Act to plan and carry out their activities in accordance with the Strategy.

Clause 42(1) of the Bill provides that, if the OGA considers that a person has failed to comply with a petroleum related requirement imposed on the person, it may give the person a sanction notice in respect of that failure (which means an enforcement notice, a financial penalty notice, a revocation notice or an operator removal notice). Thus, it will be possible for the OGA to impose a range of potentially very significant regulatory sanctions for failure to do anything which is required by the Strategy (bearing in mind that requirements under the Strategy may be imposed by the OGA without any of the procedural safeguards for relevant persons when faced with the imposition or alteration of other regulatory duties, e.g., under the offshore licensing regime).

As it stands, the Energy Bill does not limit the OGA's discretion (notwithstanding its duty to act 'reasonably' which is unlikely, as a practical matter, to provide much scope for comprehensive judicial oversight) as to how to deploy these sanctions in particular cases. It is true that the 'safeguards' proposed to be inserted in the Strategy itself do include a requirement for the OGA to have discussions with someone who has delayed or decided not to undertake investment or activity because they will not receive a satisfactory commercial return prior

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to taking enforcement action. However, this offers little practical comfort or guidance as to the nature or purpose of such discussions.

On that basis – given the obvious risks to investor uncertainty – the development by the OGA of clear guidance on the implementation of the Strategy (and, in particular, the use of its enforcement powers) is vital. Such guidance could provide considerable comfort that the OGA will apply tried and tested 'better regulation' principles (e.g. in relation to consistency and targeting) when exercising its sanctioning powers in relation to the Strategy.

Next steps

The OGA has said that it will publish further guidance on the implementation of the Strategy and how it expects relevant persons to comply with it towards the end of this year.

For further information or advice on any of the issues discussed in this briefing note, please get in touch with your usual Shepherd and Wedderburn contact.

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