Offshore Decommissioning Liability: "Hotel California" and cross-contamination risks

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Introduction

The trend of oil & gas majors and larger independents looking to exit or reduce their exposure to the North Sea has seen buyers and sellers alike grappling with the decommissioning liabilities associated with late-life assets within these portfolios and the wide-ranging reach of the Petroleum Act 1998 (the "Act").

The "Hotel California" risk for sellers

"You can checkout any time you like, but you can never leave". Sellers of UKCS E&P assets will sympathise with the final line of the Eagles' most famous record, given the "last resort" powers of the Secretary of State under section 34 of the Act to pursue previous owners, licensees and operators (and entities which had been "associated" with them) for decommissioning liabilities.

Although the Secretary of State has never exercised these powers, given the quantum of the potential liability and the increasing prevalence of smaller/less financially strong buyers, the protection offered to guard against such future default is a key consideration for sellers, who have been looking at increasingly innovative ways to mitigate against this risk and to deal with existing security they have posted. This includes:

- the seller agreeing to retain a proportion of the decommissioning liability contractually and receiving the corresponding uplift in value to the sales price – there are many different models, but the seller is likely to want to include some element of sharing in fixed proportions and a cap on its liability to ensure appropriate incentives for the buyer to keep costs down;

- the seller requiring bilateral decommissioning security agreements where there is not a fieldwide DSA in place – there are various ways in which the triggers for posting, and the quantum of, security under these DSAs can be structured and the seller will need to balance its desire for robust security with the financing constraints to which the buyer is subject; and

- the seller continuing to "front" decommissioning security required under field-wide DSAs (e.g. by leaving existing guarantees in place) and accepting a counter-indemnity from the buyer - in some cases the underlying DSAs need to be amended to allow this.

Cross-contamination issues for buyers

From a buyer's perspective, it will need to undertake a careful analysis of the application of the "associated" entity test in sections 34(8)-(8D) of the Act to establish which entities within its corporate structure will have contingent liability under the Act. We have seen particular issues arise in the context of:

- **joint ventures** – a company is "associated" with an owner/operator/licensee if it possesses or is entitled to acquire 50% or more of the issued share capital of that person. A shareholders' agreement will often contain a buy-out right upon an event of default and the underlined wording above could result in non-defaulting shareholder becoming an "associated" entity upon such a default, even if it does not exercise its buy-out right and regardless of whether the breach is remedied. This contingent liability could exist indefinitely given the "Hotel California" risk. In addition, whilst unlikely, the parties should be careful to ensure that they do not inadvertently become "associated" by virtue of having negotiated unusually robust minority protections in the SHA as a result of which a minority shareholder has the power "to secure that the affairs of [the JV] are conducted in accordance with [its] wishes"; and

- **private equity structures** – the analysis required here can be particularly complex. In the absence of careful structuring, "associated" entities could potentially include the main fund, and any other fund the investee companies controlled by the GP or by the GP of a related fund where GPs of different funds are under common control. As a result, some financial sponsors have looked to acquire E&P assets and businesses through a consortium where no single financial sponsor holds an interest of 50% or more. In other cases, sponsors have looked at careful structuring of the acquiring entity and the GP arrangements so as to ringfence the statutory liability to the maximum extent possible.

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Recent experience
We have recently acted for a number of clients, including private equity groups and independents, in relation to North Sea acquisitions and joint ventures involving innovative decommissioning liability and cost sharing arrangements and structural solutions to mitigate risk.

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