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**ENERGY IN
TRANSITION –
THE ROLE OF
DECOMMISSIONING**



– THOUGHT LEADERSHIP

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ENERGY IN TRANSITION – THE ROLE OF DECOMMISSIONING

Decommissioning is an integral part of the energy transition. The move by oil & gas companies to decarbonise their operations often leads to a transfer of their ageing assets to new, and often under-resourced, players. This can create opportunities but is also fraught with complexities and challenges for both outgoing and incoming operators.

In this extract from a recent webinar, our experts discuss the risks arising in decommissioning operations, offer suggestions on how to mitigate and manage those risks, and identify key factors for any robust decommissioning strategy.



There are many aspects to decommissioning that range from the more obvious categories, such as safety and environmental regulation, but also include areas such as corporate structuring to deal with issues of trailing liability, financing and risk transfer through the contracting chain.



— **SPENCER FLAY**
Partner

What is decommissioning and why is it important?

When we talk about energy transition, we often think about renewable energy projects that will replace existing sources of energy such as coal, oil and gas and nuclear. But it's also important to consider what happens to those existing assets and whether they can be repurposed or replaced in a responsible way, and the regulatory environment that governs that transition.

"There are many aspects to decommissioning that range from the more obvious categories, such as safety and environmental regulation, but also include areas such as corporate structuring to deal with issues of trailing liability, financing and risk transfer through the contracting chain" says Perth-based Partner Spencer Flay. It's a huge issue. Global decommissioning spending for the period 2021 to 2030 has recently been forecast at approximately US\$100 billion.

So how do companies dispose of fossil assets when they are no longer profitable and/or the company wishes to exit the sector – either by selling the assets, ring-fencing those assets in a corporate reorganisation, or simply shutting them down? This question is obviously relevant to more than just oil & gas assets. It includes mines, fossil-fuelled power plants, refineries, storage facilities and pipelines.

Assets in US Outer Continental Shelf (OCS) – what are the issues?

"Oil & gas assets in the OCS are a good starting point when thinking about the issues involved, because there's an established system in place which likely informs what will happen elsewhere in dealing with the sale or retirement of fossil assets", says Washington-based co-head of the Americas Energy and Projects Group, David Evans.

It's not just about who is responsible for decommissioning costs (or liability) associated with OCS assets, there are also larger issues of liability for events at the site – whether during operations, as part of decommissioning or afterwards. This can amount to the same thing in some circumstances. "For example, if there's a major accident at an offshore site – like the Deepwater Horizon drilling rig / Macondo well blowout – the concepts of decommissioning costs and environmental and safety liability to third parties are one and the same," says Evans. These issues are beyond the scope of this briefing, but it's important to keep the bigger picture in mind.

Assets on the OCS are structured as concessions – there will be a lease by the US Federal government to explore for and develop hydrocarbons in Federal waters, being those more than three miles offshore. After a competitive bidding process, the Bureau of Ocean Energy Management (BOEM), part of the Department of the Interior (DOI), will enter

into a lease with the winners, which may then bring other oil & gas companies into the project to share the risks.

BOEM also grants necessary rights-of-way (ROWs) and easements for companies to develop offshore assets, such as pipelines to bring products ashore. A separate agency of the DOI, the Bureau of Safety and Environmental Enforcement (BSEE) is, as the name implies, responsible for environmental protection and safety in the activities of lessees.

"No one will be surprised that decommissioning is considered at the very outset of this process," says Evans, "neither the US government nor owners and operators start thinking about who will pay for decommissioning only at the end of a field's economic life."

BOEM addresses decommissioning both through its Regulations, which have the force of law, and the contractual provisions of its leases. The Regulations provide that a company incurs decommissioning obligations when it drills a well, installs a platform, pipeline or other facility; or creates an obstruction on the OCS.

The decommissioning liability obligations of the Regulations kick in whenever the company obtains a right to an OCS lease, a ROW or a right-of-use-and-easement, whether by an initial grant from the Federal government or by assignment from someone else.

"Decommissioning liability under the regulations is joint and several, which means that any company that has decommissioning liability for an asset – that is, that owns it at any point – can be liable for the entire cost of decommissioning", says Evans.

The standard BOEM lease makes decommissioning a contractual obligation of the lessee or easement holder. BOEM does this both by text in the document and by incorporating its Regulations by reference. The standard OCS lease provides that the governing law is that as is in effect from time to time, so any amendments to the regulations automatically adjust – most likely ratchet up – the decommissioning obligations.

The role of legislation

The OCS Lands Act (OCSLA) requires that OCS lessees provide "financial assurance" of their ability to perform all their obligations under the leases, including decommissioning. This financial assurance can be provided by surety bonds, or other forms of security acceptable to BOEM, such as US Government instruments. The financial assurance requirement also attaches to assignments to a new company. The amount of the bond increases with activities – starting relatively modestly at US\$50,000 at the time of signing the lease, increasing with the commencement of exploration activities, and further increasing to US\$500,000 at production. Similar financial assurance is required for easements and ROWs. "Creditworthy companies may not have to post surety bonds to show financial assurance, given their capacity to cover decommissioning costs. BOEM now refers to this as self-insurance, rather than as a waiver of the bond requirements", says Evans. A prior practice of allowing co-lessees to rely on the financial strength of one another was discontinued in 2016 after one such co-lessee went bankrupt. Now, each co-lessee must show financial assurance.

As noted, decommissioning responsibility owed to the Federal government is joint and several and BSEE can follow the ownership chain anywhere, if needed, to obtain funding to cover decommissioning. In 2022, BOEM proposed an amendment to its Regulations that would look to the nearest-in-time owner for decommissioning costs and proceed to recover decommissioning costs in reverse chronological order. However, this rule has now been withdrawn, and so the joint and several regime remains, with BOEM saying it will pursue parties in the "most efficient" manner, which seems quite discretionary.

It is notable that responsibility for actually enforcing decommissioning obligations – and collecting the money if necessary to do so – falls on BSEE, not BOEM.

Effectively, decommissioning liability to the Federal government under the OCSLA cannot be avoided and joint and several exposure remains for any entity in the ownership chain, regardless of how far back their ownership ceased.



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**— DAVID EVANS
Senior Counsel**



[The UK regulator's] power may in theory be used after completion of the decommissioning programme to ensure parties remain liable for any future unseen failure.



**— KIRSTY SOUTER
Senior Associate**

However, this does not mean that private parties cannot attempt to allocate responsibility for decommissioning costs amongst themselves by contract.

OCSLA provides that the law governing contracts in the OCS is that of the most proximate state – which usually will mean Texas or Louisiana law. Assigning liability for decommissioning mostly arises under assignment agreements or in the assignment clauses in sale and purchase agreements, transferring the ownership and operation of a well. In short, both Texas and Louisiana (with its Civil Law system) have been reluctant to excuse an assignor from decommissioning liability unless the contract was clearly drafted to assign both rights and obligations.

You can read more about the allocation of decommissioning liability between owners and contractors in our recent briefing [Offshore Decommissioning Contracts – Operation of the Knock for Knock Regime](#).

So, are there ways of mitigating decommissioning liability in the US? Evans says, "As far as Federal government is concerned, no. The BOEM Regulations, lease terms, financial assurance criteria and the joint and several regime defeat any such attempt. But as between private parties – buying and selling such assets – perhaps ... given good contract drafting and a sympathetic judge."

The regime for UK North Sea assets

"The position is broadly similar under the UK regime for North Sea assets", says London-based Senior Associate Kirsty Souter. The key principle underlying the UK regime is that decommissioning costs should be borne by those who have gained a financial benefit from the asset, rather than by the UK taxpayer.

What this means is that anyone with a connection to a licence interest can ultimately be held responsible for decommissioning liabilities. Decommissioning obligations arise when the regulator – the North Sea Transition Authority (NSTA) – serves a so-called Section 29 Notice. Current practice is for a Section 29 Notice to be issued on the

date when construction of the asset starts. A Section 29 Notice will include an obligation to submit a decommissioning programme to the regulator for approval. Once approved, all Notice Holders must comply with the decommissioning programme on a joint and several liability basis, meaning that one Notice Holder can be liable for the full costs of the decommissioning programme if other Notice Holders are unable to fulfil their obligations under the programme.

Who can be served a notice? The NSTA will start by serving a notice on each operator, owner, licence interest holder and party to any joint operating agreement. It also has the power to serve a Section 29 Notice on any other person owning an interest in the installation or pipeline and on an associated body corporate of any operators, owners, licence interest holders and Joint Operating Agreement (JOA) parties. Broadly, an associated body corporate is one under common control with the relevant operator, owner etc or which is controlled by them.

"While this definition is broad, the regulator's policy in the first instance is to serve Section 29 Notices on the current operators, owners and so on. It may only serve a Section 29 Notice on an associated body corporate where it believes that satisfactory arrangements have not been or may not be made to ensure a satisfactory decommissioning programme is carried out", says Souter.

The regulator expects the operator to report regularly on the progress of decommissioning activities, and, if it believes that the decommissioning is not being satisfactorily carried out, it can use its statutory powers to intervene. These include issuing a notice directing the Notice Holder to undertake remedial action (non-compliance with which is a criminal offence) and recalling previous Notice Holders and placing them under a duty to carry out a decommissioning programme. It can also impose this duty on any person upon whom a Section 29 Notice *could* have been served. In this way, contingent liability continues in perpetuity even where entities have been released from a Section 29 Notice.

So decommissioning liability will not necessarily come to an end when the works set out in the decommissioning programme are finished. It is possible for the decommissioning programme to contain, or the regulator to require, ongoing monitoring and maintenance work extending beyond completion of the decommissioning programme.

After completion of the decommissioning programme, the Notice Holder must submit a close-out report within one year of the completion of offshore work. The Secretary of State will then review the report and, subject to any points for clarification or further ongoing monitoring requirements, notify the Notice Holder when it accepts the report. This process does not affect the Notice Holder's residual contingent liability, but acceptance of the report does mean that security will no longer be required under the relevant decommissioning security agreement.

The UK regulator can impose a duty to carry out a decommissioning programme on any person upon whom a Section 29 Notice could have been served, or any person previously released from a Section 29 Notice. This power may in theory be used after completion of the decommissioning programme to ensure parties remain liable for any future unforeseen failure (for instance, if any work is required on any infrastructure remaining in situ or in the event of any environmental leakage). The NSTA regards this power as a "measure of last resort" and, as far as we know, a situation like this has not previously happened.

Decommissioning and M&A

"We have seen the mix of players in the UK North Sea change over time, given its status as a mature oil and gas basin. More non-traditional oil and gas-owning entities such as private equity houses and other financial institutions have entered the space alongside the traditional international oil companies and small to mid-cap oil and gas companies, with diverse approaches on risk tolerance and investment horizons and with more varied credit positions", says London-based Director, Leo Rudolph. Given the amount of M&A activity this has generated, decommissioning comes up time and

again as a key issue that needs to be managed. "There is a need to manage exposure to decommissioning liability amongst the current field participants, as well as between purchasers and sellers and other past licence-holders", he says.

A key commercial tool to help try and adequately balance such risk is decommissioning security, both in terms of security granted to cover off liability to the regulator but also as between each of the JV partners, and outgoing / incoming license holders. The UK space is well-developed in this sense and even has an industry standard approach to the decommissioning security agreement (DSA) that sets out the terms and conditions for decommissioning security that NSTA and participants would generally accept. Such DSAs would address the amount, timing and form of security that would be posted by parties relating to security in different circumstances.

From an M&A perspective, sellers often want a clean break and ask the purchaser to provide them with an indemnity for the future decommissioning liabilities. However, in doing this the seller takes a credit risk on the purchaser. To address this, sellers may ask for decommissioning security from the purchaser (particularly for thinly capitalised and agile market entrants), but where this is needed it can have an effect on the asset valuation and purchase price. For this reason, we often see assets with high decommissioning liabilities combined with earlier stage producing assets to provide a more attractive package. Consideration will also need to be given to overlap of security, where purchaser posts or the seller has posted security.

Decommissioning in Australia

"While it's still a fairly nascent area, there's already quite a lot of decommissioning activity in Australia. Around AUS\$60 billion of offshore decommissioning activity is expected in Australia in the next 30 to 50 years", says Perth-based Director Pat Saraceni. As part of its focus on promoting energy security and net zero, the Federal Government in its recent budget has set out a "Roadmap for Establishing a



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**—LEONHARD RUDOLPH
Director**

- "related person" includes both companies and individuals, specifically a related body corporate (under sections 46 and 50 of the Corporation Act this includes a holding company or a subsidiary or a subsidiary of the holding company) or related person of the current or former titleholder;
- a person who significantly benefited or was capable of benefitting from the operations, which could include a shareholder who has derived substantial benefit;
- a person in a position to influence compliance; or
- a person who has acted jointly with the titleholder.

Decommissioning Industry in Australia" and has allocated funding to it. In addition, in 2022 the government introduced an enhanced legislative regime for offshore decommissioning.

Australia's offshore energy regulators for decommissioning activities in Commonwealth and coastal waters are the National Offshore Petroleum Safety and Environmental Management Authority (NOPSEMA), and the National Offshore Petroleum Titles Authority (NOPTA). NOPSEMA has a broad remit, including structural well integrity, environmental management and greenhouse gas storage activities.

"NOPSEMA encourages companies to commence planning their decommissioning from the design and construction stage and throughout the lifecycle of the project – not just at end of life", says Saraceni. "It has developed a five-year Compliance Strategy which it implements by assessing the risk of each production facility and categorising it as high or low risk – not as an end-of-life issue."

The regime that covers offshore decommissioning is the Offshore Petroleum and Greenhouse Gas Storage Act 2006 (OPGSSA), together with associated regulations and industry guidelines. These are reviewed regularly to ensure that they are "fit for purpose". Certain amendments were introduced in 2022 to increase oversight and enforcement by the regulator.

"NOPSEMA can issue directions to both existing and former titleholders and also to their "related persons" to remove property, plug wells, and undertake remediation work", says Saraceni. "The focus is on ensuring that decommissioning costs and liabilities are borne by the oil & gas industry."

Some notable key features of the regime are:

- **Primarily titleholder responsibility** – decommissioning costs are first and foremost borne by the current registered titleholder, for example JOA parties. All decommissioning activities are to be undertaken before surrender of the title.

- **The base case assumption is total removal of the assets** as per the 1982 United Nations Convention on the Law of the Sea (UNCLOS), but partial removals are permitted if the environmental outcomes are no worse than total removal.

- **Trailing liabilities (for titles held from 1 January 2021)** – if the existing titleholder fails, there is now very broad scope to "call back" a "related person" to undertake remedial work. Trailing liability applies on an ongoing basis so parties can face a remedial direction at any point after their title ceases.

- **Financial assurance for marine oil pollution** – titleholders must have, and maintain throughout the life of the project, financial assurance to satisfy any potential liabilities that may arise from petroleum activities. This will be a condition of approval of the environmental plan. Titleholders can select a cost-calculation method for estimating the quantum of financial assurance, but that will require independent validation. The Australian Petroleum Production and Exploration Association (APPEA) has developed a recommended method of calculation.

- **Change in Control of registered titleholder** – approval is required not just for a direct asset transfer but also for a change in control of a titleholder entity, for example via a merger, restructure or acquisition. The aim of this requirement is to have greater oversight over transactions, to ensure that new owners have the financial and technical capability to deal with decommissioning.

- **Stricter suitability requirements and scrutiny of applicants** – taking into account technical competence, financial capacity, past performance and compliance history, and corporate governance.

"These measures are expected to positively influence industry behaviours in a very practical sense, leading to increased awareness and industry standards", says Saraceni.

"They force operators to look beyond their own decommissioning capabilities and to assess the capability of their JV participants and prospective purchasers of their offshore assets, lest they are called back to remediate problems arising long after they have divested the asset."

Looking forward, the challenge for Australian regulators will be to look in greater depth at the tax treatment of decommissioning liabilities and to explore more innovative financial assurance models.

What's happening in the APAC region?

The APAC region, especially Indonesia, Malaysia, Vietnam and Thailand, is potentially a huge market for decommissioning, with a high number of relatively small structures and wells. In many jurisdictions, the legislative framework for decommissioning is either non-existent or less mature, and some of the older production sharing agreements and concession agreements did not consider decommissioning at all.

This is rapidly changing, and some of the oil & gas majors are taking proactive steps to help shape the decommissioning regimes emerging in the region. In 2012 the ASEAN Council on Petroleum published its "Regional Decommissioning Guidelines" (ASCOPE) as a starting point to address decommissioning issues and some jurisdictions, including Thailand,

Brunei Darussalam, Vietnam and Malaysia, have started to implement these guidelines. The regimes of Australia, the North Sea and the Gulf of Mexico will no doubt act as a guide for developing regulation in this area.

Risk mitigation

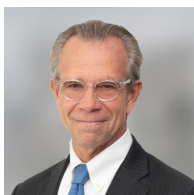
Finally, although the focus of this discussion has been on the regulatory framework and consideration of how this impacts transactions and investment decisions, there are additional ways in which risk can be mitigated; these can be addressed in transactional analysis and discussed among stakeholders. For example, it is important to factor decommissioning planning into the front-end of construction and development contracts so that end of life costs can be mitigated or reduced over the operational lifetime of the assets, having regard to best industry practice in the design and construction phase.

Although risk cannot legally or commercially be outsourced fully to contractors under decommissioning contracts, some risk can be mitigated by ensuring that the work is allocated appropriately between the operator and the contractor and thinking carefully about the allocation of risk within the scope of remedies for defects.

[The measures] force operators to look beyond their own decommissioning capabilities and to assess the capability of their JV participants and prospective purchasers of their offshore assets.

**—PAT SARACENI
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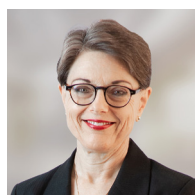
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