Freshfields Bruckhaus Deringer

Don’t forget your DSAs: points North Sea E&P companies should keep on their radars in the current low oil price environment.

Oil & gas industry veterans are no strangers to oil price volatility. Yet the sheer scale of the collapse in demand from Covid-19, compounded by an ill-timed supply glut flowing from the Saudi/Russia price war, has sent the industry reeling.

With Brent Crude and West Texas Intermediate falling to levels not seen since 2002, global storage capacity rapidly filling and the prospect of production shut-ins looming, oil & gas companies worldwide are assessing their liquidity positions, rushing to secure capital, deferring capex projects and slashing costs to put themselves in the best position to weather the storm.

North Sea decommissioning

Whilst it might not be front of mind in present circumstances, E&P companies operating in the North Sea should not lose sight of their decommissioning security arrangements and the potential impact these could have on their liquidity analyses.

A sustained period of subdued energy prices could rapidly bring forward the end of life for ageing North Sea fields and infrastructure. North Sea E&P companies should ensure they are stress-testing existing assumptions around the crystallisation of decommissioning costs accordingly.

Even for assets with more distant maturities, the implications of the current crisis under the decommissioning security agreements (DSAs) widely used across the North Sea could be immediate. For those participants subject to a more onerous ‘umbrella security agreement’ of the type recently seen emerging (requiring the provision of security for routine cash calls in addition to decommissioning obligations), the implications could be even more acute.

DSA implications of COVID-19

Although a variety of forms of DSA appear in the North Sea, with the UKCS and NCS standard DSAs having their basis in different models, they tend to follow similar fundamental principles. Whilst DSAs should be individually reviewed, these points are likely to be of general application.

1. *Rating downgrades:*

As crashing oil prices and the coronavirus outbreak continue to impact the market, with oil & gas bonds trading well below par, rating agencies have slashed their commodity price assumptions and downgraded the credit ratings of many oil & gas issuers – including majors.

Rating downgrades could result in parent company guarantees that have been provided as security for future decommissioning obligations ceasing to qualify as acceptable security (or ‘Qualifying Surety’) under the DSA. This would result in the licence holder being required to provide alternative security in a relatively short timeframe, either through a cash payment of the required provision amount into trust or (more typically, to the extent commercially available) the provision of a bank guarantee or letter of credit.

Where a rating downgrade triggers these implications across a large North Sea portfolio, or a portfolio including assets with significant anticipated decommissioning liabilities, the aggregate effect of the security requirements under all the relevant DSAs could put significant strain on debt capacity and liquidity.

2. *Asset valuations:*

DSAs typically require a recalculation and re-posting of security on an annual cycle. The amount of security to be provided is usually calculated by a formula which takes into account, among other things, the ‘Net Cost’ of anticipated decommissioning expenditure relative to the ‘Net Value’ of the licence interest. The effect is that increasingly more security needs to be posted as decommissioning plans are brought forward and as the ‘Net Value’ in the asset declines with the field approaching the end of its useful economic life.

The ‘Net Value’ component of the formula therefore operates as a buffer before security needs to be provided or, once the requirement to provide security arises, to reduce the amount that needs to be provided. Since the determination of the ‘Net Value’ takes into account the value of sales from forecast production, revisions to both commodity price assumptions and the production profiles of assets as a result of the current crisis could have a potentially material adverse impact on the amount of the ‘Net Value’. This would have the corresponding effect of eroding the security buffer for licence holders, potentially bringing forward the requirement to provide security and increasing the provision amount. The calculation of security amounts this year could be particularly challenging given the unprecedented nature of the volatility.

There may be some silver lining. Many standard DSAs will not require a recalculation of the security provision amount until the end of June, with this process sometimes stretching until later in the year and security often not needing to be posted until the end of November, and perhaps things will have improved by then. That said, whilst the recent OPEC+/G20 rapprochement, brokered to some degree by the US, may have eased the depth of the price collapse, the extent of the global decline in demand is widely expected to see low prices remain for a sustained period and the economic and geopolitical headwinds facing an industry already under siege should not be underestimated. Against this backdrop, North Sea E&P companies would be well advised to take a conservative view in their preparation for upcoming decommissioning security recalculations.

3. *Debt facilities:*

North Sea E&P players affected by the issues described above will already be assessing their debt facilities and reserve based lending redetermination calendars as part of their liquidity review processes. An important part of this review should be an examination of existing credit lines to ensure ready access to bank guarantee or letter of credit facilities sufficient to cover any anticipated increase to DSA security requirements.

They should also be wary of the impact maintaining these facilities could have on their debt capacity when assessing near term liquidity. The potential for DSA counterparties to eat into borrowing headroom by calling for additional letters of credit could be of great concern to CFOs at this difficult time. Companies should also ensure that any new financing raised in response to the crisis appropriately accommodates the provision of security under DSAs (as ‘permitted indebtedness’, ‘permitted security’, etc.).

What should North Sea E&P companies be doing about this in practice?

- Review DSAs to understand the impact ratings downgrades and declining asset valuations could have and any other implications. Where there is a large volume of DSAs, Freshfields’ AI technology can help to extract the relevant provisions with maximum efficiency.
- Consider annual DSA cycles to anticipate when calculations are likely to be made or ‘trigger dates’ for the provision of security may occur. Begin planning the approach to recalculations (including pricing assumptions) and to managing the impact of any resulting security requirements on liquidity.
- Stress-test assumptions around field life in a low oil price environment or in the event of production shut-ins.
- Be alive to decommissioning security requirements when negotiating new financing facilities. Ensure there is sufficient headroom and facilities in place to draw letters of credit where needed and that doing so is not restricted by debt covenants.
- Be vigilant as to the financial position of DSA counterparties and any rating downgrades affecting them in case it becomes necessary to call for additional security.

If you have questions, please ask.

We will be continuing to monitor developments related to Coronavirus and major projects and update our briefings as the situation evolves. For further Freshfields thinking, see our updates on our Coronavirus Alert Hub.

For more information, please contact

Alon Gordon
Senior Associate
T +44 20 7427 3960
E alon.gordon@freshfields.com

Joshua Critchlow
Associate
T +44 20 7427 3555
E joshua.critchlow@freshfields.com

freshfields.com