UK

Use it or lose it

***Stuart Ward*, *John Gilbert* and *Alastair Young*, Bracewell lawyers,** **examine the OGA's test for what constitutes a 'satisfactory expected commercial return' for an oil and gas project in the UK.**

In December 2017, the Oil and Gas Authority (OGA) – the primary regulator of the UK's oil and gas industry – issued a consultation paper on its 'objective test' to determine whether proposed upstream or infrastructure projects will have a 'satisfactory expected commercial return' (SECR) for sponsors. Penalties could be imposed on companies not pursuing projects which would achieve a SECR.

The OGA's proposed test goes to the heart of the economics of UK oil and gas projects, and many of the industry's stakeholders actively engaged with government on the consultation.

What is SECR?

Under Part 1A of the Petroleum Act 1998, persons including holders of exploration and production licences, oil and gas infrastructure owners and the OGA itself, must act in accordance with the Maximising Economic Recovery Strategy for the UK (MER UK Strategy). The central objective of the MER UK Strategy is to secure that the maximum value of economically recoverable petroleum is recovered from the strata beneath relevant UK waters. Companies declining to make an investment or fund a project – including an exploration or development project – can be compelled by the OGA to divest themselves of the relevant asset or face sanction (including fines and asset revocation) under Chapter 5 of the Energy Act 2016.

However, the MER UK Strategy currently includes a 'safeguard', which provides that companies will not be sanctioned for a failure to invest in or fund a project which will not yield a 'satisfactory expected commercial return'. The MER UK Strategy defines SECR to mean: '*an expected post-tax return that is reasonable having regard to all the circumstances including the risk and nature of the investment (or other funding as the case may be) and the particular circumstances affecting the relevant person*'.

In recognition that each project has unique features, the definition was described as 'deliberately flexible' by the then responsible Minister of State, Andrea Leadsom MP, who went on to explain during Parliamentary sessions in relation to the MER UK Strategy that it is 'not realistic even to attempt to set a clear figure on what a satisfactory expected commercial return would be'.

Proposed objective test

The OGA is now proposing that there should be an 'objective and pragmatic test' to determine SECR. The proposed test is whether the expected probability weighted post-tax net present value (NPV) of the project, using a set discount rate (X% nominal), is positive and achieves a discounted profitability index (DPI) of Z or greater. For the discount rate (X) the OGA is proposing using a weighted average cost of capital (WACC) and is proposing a discount rate within the range of 6.9% to 8.3% nominal for upstream projects, and within the range of 4.9% to 7.2% nominal for infrastructure projects. For the DPI 'Z', the OGA is proposing a range of 0.2 to 0.3.

The consultation document explains that this test is based on what an 'efficient company' would consider to be a satisfactory post-tax return. The concept of an efficient company is not used in the MER UK Strategy, however. Nor does the OGA explain the methodology by which it might apply this test as part of its SECR decision making process.

MER UK Strategy revisions

Legally binding revisions to the definition of SECR – and any other aspect of the MER UK Strategy – must follow a consultation and pass through both Houses of Parliament in accordance with the procedure set out in sections 9F and 9G of the Petroleum Act 1998. The UK government is not following that procedure in this instance.

Industry reaction

Some of those who would like to see the OGA reconsider or revise this proposed test have stated that the test sets the bar too low and by doing so repurposes SECR from a safeguard into a sword which could be used against industry by government. It has also been noted that this test could do more to take into account the subjective, as well as objective, elements of the SECR definition as set out in the MER UK Strategy, as economic analysis and investment decisions are not purely objective.

It has been argued that focusing on an objective test could distort the market and deter investment, which is itself inimical to the MER UK Strategy. There was over $8bn of M&A activity in the UK offshore industry during 2017; however, the industry body Oil & Gas UK is forecasting a lower value of total M&A activity during 2018 in its latest *Business Outlook* report.

Some other industry participants may be more supportive of the government's SECR initiative. For example, some companies may consider that there are older oil fields or other associated assets in the UK which are not being exploited to their full economic potential. They may consider that the government's SECR test could force the relatively inactive owners of those assets to either become more active or divest, in turn creating buy-side opportunities for newer entrants and acquisitive players.

The consultation closed on 1 March 2018 and industry is awaiting the government's response to the consultation. ●