

INSIGHTS

DSAs: Calculating Security and the Role of Expert Determination

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Decommissioning. A word familiar to all of those who are involved in oil and gas exploration and production around the globe. It is defined in the Cambridge English Dictionary as “*taking a factory or other industrial building out of use and making the area safe*”. However, this fails to convey the technical difficulty and extreme cost that is associated with decommissioning offshore oil and gas facilities in mature production areas, such as the UK North Sea.

For a long time, decommissioning was seen as a problem for another day. However, as more and more fields enter into their twilight years, that day is very much upon us. According to OEUK, £1.27bn was spent on decommissioning activities in the UK North Sea in 2021. This was expected to increase to almost £2bn in 2022 and to approximately £2.25bn by 2030.^[1] OEUK anticipated that 196 wells would be decommissioned in 2022 and has stated that drilling activity is now only around one quarter of the rate of well decommissioning.^[2] The era of decommissioning has arrived, and it is here to stay.

There will, no doubt, be many disputes in the future in relation to the decommissioning activities themselves. However, we are already seeing disputes arising under decommissioning security agreements (“DSAs”), which ultimately come down to estimating the costs of the decommissioning operations. The latest example is the case of [Apache North Sea Limited -v- Esso Exploration and Production UK Limited & Ors \[2023\] EWHC 1345 \(Comm\)](#).

What was the dispute about?

The dispute arose from the operator’s calculation of the security to be posted for 2023 under the terms of the applicable DSA (an amended version of the industry model form DSA). The calculation was disputed by the other parties to the DSA, and the matter was referred to an expert for determination. However, the operator sought an injunction on the basis that disputes about the calculation of the security under the DSA concerned the construction of the DSA and should be resolved by the English Courts. This led to an expedited trial where the Court had to decide a number of issues concerning the calculation of the security and the exercise to be undertaken by the expert to whom the matter had been referred for determination.

What are DSAs?

Under the relevant legislation, the liability for decommissioning costs can fall on the current or former owners of offshore installations and pipelines.^[3] For this reason, DSAs are normally put

in place when a transfer of ownership of the installations and/or pipelines occurs. As stated by the Court in this recent case, the purpose of a DSA is to “*require the [current owners] to provide security to cover the future costs of decommissioning to which otherwise the [former owners] would be exposed*”. In essence, DSAs exist to minimise the risk that the current owners are unable to fund the decommissioning costs when they fall due.

This means that there is an inherent tension in a DSA between the former owners, who want to ensure that sufficient security is posted to minimise their own risk, and the current owners, who want to minimise the amount of security they must put up.

What did the court decide?

The Court determined the following:

1. The usual rules of contractual interpretation apply when construing the terms of a DSA. In particular, the Court determined that the DSA in question was a “*sophisticated, complex agreement drafted by skilled professionals which should be interpreted principally by textual analysis*”. The Court highlighted that the exercise of interpreting contractual provisions is “*not about re-writing the contract after the event in the apparent interests of one party over another*”. The English Courts will not rescue a party who has made a bad bargain.
2. The amount of security to be posted (if any) was determined by a formula in the DSA in which the key variables were “*Net Cost*” and “*Net Value*”, both of which were forward-looking estimates to be prepared by the operator. A key element in calculating Net Value is the hydrocarbon reserves that are estimated to be commercially recoverable. The Court determined that the DSA did not *require* the operator to include estimated decommissioning costs or inflation on those costs when calculating the estimate of commercially recoverable reserves. It said that it was for the operator to decide whether or not to take account of inflation. However, if the operator decided to do so, it must have made that decision in accordance with the Reasonable and Prudent Operator standard. The Court noted that if the approach taken is commercially insensible, then “*by definition it is not one that could be arrived at by applying the Reasonable and Prudent Operator standard*”.
3. The Court dismissed the suggestion that the question for the expert was whether the operator had reached conclusions that no reasonable operator applying the Reasonable and Prudent Operator standard could have arrived at. On the wording of the DSA, the expert is required to determine two distinct questions: First, whether the operator’s estimates of Net Cost and Net Value were calculated in accordance with the DSA, and second, and only if the first question is answered in the negative, how the estimates should have been calculated. The expert is required to determine both questions by reference to what, in his judgment, a Reasonable and Prudent Operator would have prepared. The expert is, therefore, to form his own view.
4. The expert must, in reaching his determination, take into account the impact of the Energy Profits Levy. This determination turned on the specific facts of this case. However, it is a further example of the impact the Energy Profits Levy is having on the North Sea oil and gas industry.

5. The expert can proceed to make his determination, notwithstanding that there is a dispute as to the proper interpretation of the DSA. The expert is permitted to form his own view of how the relevant provisions should be construed. If one of the parties considers that he has formed an incorrect view, and if the DSA permits, they can subsequently challenge the expert's determination in the courts. The judge said that this interpretation "*eliminates the risk that a court will be required to determine academic points or points other than in relation to material facts and enables disputes to be resolved in a manner that is relatively inexpensive and speedy*". However, this raises the question of whether a challenge of the expert's determination is all but inevitable if issues of construction are left outstanding until after the determination has been made.

Conclusion

As fields age and the date when it will be necessary to carry out decommissioning approaches, the issues that arise in relation to the calculation of the cost of decommissioning become more acute and concerns about who will bear that cost may increase. In a time when the cost of capital is high, companies will want to avoid tying up funds in putting up security. The combination of these factors is likely to give rise to further tension between current and former owners and increases the potential for future disputes.

[1] OEUK Decommissioning Insight Report 2022 - https://oeuk.org.uk/wp-content/uploads/woocomerce_uploads/2022/11/Decommissioning-Insight-2022-OEUK-nglyb1.pdf

[2] OEUK Business Outlook 2023 - <https://oeuk.org.uk/wp-content/uploads/2023/03/Business-Outlook-2023-Offshore-Energies-UK-OEUK.pdf>

[3] See our previous briefing on another English High Court decision concerning decommissioning liability [here](#).