Guide to insolvency in the UK oil and gas industry

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Introduction to common participants in the market

The oil and gas industry is a significant contributor to the UK economy:

- it supports around 375,000 jobs (both directly and indirectly)
- the industry contributed 0.8% of GDP in the second quarter of 2015 (down from a high of 2.5% in the second quarter of 2008)
- the UK is the second largest producer of oil in Europe and the third largest producer of gas

Historically, the industry has been buoyant, and insolvency practitioners have not had much involvement. In 2010, there were just four insolvencies in the sector. However, as has been well documented, in 2015 oil prices hit an all-time low which saw insolvencies in the sector rise to 28 for that year. As a result of its maturity, the UK continental shelf is amongst the more expensive places in the world to produce oil: it costs US$40 to produce a barrel of oil in the UK compared to less than US $5 in Kuwait.

Companies which borrowed money to invest in infrastructure against an assumed oil price of US$75 or US$100 a barrel are now struggling to service the loans. Consequently the distress in the sector has significantly impacted the profitability in the UK, and needed the attention of restructuring and insolvency practitioners. Oil and gas companies are being forced to look for debt restructuring. On balance, they are seeking to refinance on better financial terms that reflects the lower oil price or debt restructuring to avoid default, such as renegotiating terms to extend the payment dates.

The oil and gas industry is composed of:

- upstream operations (also known as the exploration and production (E&P) sector) ie searching for and recovering or producing crude oil and natural gas
- the midstream sector ie processing, treating, storing and transporting crude oil and natural gas; and
- downstream operations ie refining crude oil and then selling and distributing natural gas and products derived from crude oil (midstream operations are sometimes incorporated into the downstream sector)

This Practice Note focuses on upstream operations and, in particular, the UK offshore model.

There are a large number of participants in the area:

- E&P companies—companies which hold the licenses to extract oil and gas
- oilfield service providers (OFS)—companies which provide support services to the oil and gas industry throughout its cycles of exploration, appraisals, development and decommissioning
- oilfield equipment manufacturers—producers of the specialist equipment used in the E&P sector
- investors—given the financial distress in the sector, 'non-traditional investors' such as private equity houses and integrated chemical groups are entering the sector
- Oil & Gas UK—the UK industry body
- government agencies—the industry is heavily regulated by a large number of government agencies:
    - Oil & Gas Authority (OGA) (part of the Department for Energy and Climate Change (DECC)) is responsible for licensing offshore oil and gas activities and is accountable to the Secretary of State
    - Health & Safety Executive, Department of Energy and Climate Change and the Maritime and Coast Guard Agency are responsible for health and safety and environmental protection of offshore operations under a tripartite arrangement
    - Environmental Agency (EA) is responsible for environmental regulation of all onshore oil and gas operations
    - Office of Gas and Electricity Markets (Ofgem) is responsible for the regulation of downstream gas markets

References:

House of Commons Library Briefing Paper: UK offshore oil and gas industry—22 March 2016

Legal basis for exploration and production

The UK government controls UK offshore production by granting licenses through the OGA to E&P companies in regular licensing rounds. These licenses are granted for a nominal annual license fee and the UK government derives revenue from the licenses by taxation on the production that the licensee wins from the license.

The licenses are granted for a set period of time and geographical area and contain obligations which have significant financial and work obligations. The licenses cover exploration, appraisal, development, production and decommissioning.

Exploration and Production Licence ('E&P Licence')

Pursuant to the terms of the Petroleum Act 1998 (PA 1998), the Crown owns all the oil and gas within the UK and its territorial waters and has the exclusive right to search, bore for and extract it.

Section 3 of the PA 1998 grants the OGA the power to grant licences to search and bore for and extract oil and gas. There are three different types of licences for offshore exploitation, and a separate licence for onshore exploitation. The terms of these licences known as 'Model Clauses' are set out in statutory instruments including the Petroleum Licensing (Production) (Seaward Areas) Regulations 2008, SI 2008/225 which, at Clause 41, gives the Minister the right to revoke the licence on various grounds including formal insolvency and making an arrangement or composition with creditors.

References:

PA 1998, s 3
The Petroleum Licensing (Production) (Seaward Areas) Regulations 2008, SI 2008/225

These grounds include:

- any payments due under the license being in arrears or unpaid for two months after any of the days whereon the same ought to have been paid
- in Great Britain, the bankruptcy or sequestration of the licensee
- in Great Britain, the making by the licensee of any arrangement or composition with his creditors
- in Great Britain, if the licensee is a company, the appointment of a receiver or administrator or any liquidation whether compulsory or voluntary
- in a jurisdiction other than Great Britain, the commencement of any equivalent insolvency procedure to those listed above
- any breach or non-observance by the licensee of the terms and conditions of a Development Scheme; and
- if the licensee is a company, the licensee's ceasing to direct and control either its operations under the licence; or any commercial activities in connection with those operations, from a fixed place within the United Kingdom

Licences are issued following a competitive licencing round which takes place approximately once a year. A rental fee which is charged at an escalating rate for each square kilometre covered by the licence is payable annually.

The OGA will play a pivotal role in any restructuring process. Pursuant to the terms of the Model Clauses, the OGA has the power to revoke a licence on insolvency of the operator, following a change in control or if the annual licence fee is not paid, in which case they also have a right of distress.

Some older licences are also, in theory at least, terminable on the insolvency of only one of the co-venturers to a licence. This risk has led to solvent co-venturers seeking to acquire the share of any co-venturer that is likely to be close to insolvency. Licences cannot be sold, transferred or assigned without the consent of the OGA. When deciding whether or not to grant consent, the OGA will consider the technical and financial capability of the assignee/transferee.

A licence cannot be charged without the consent of the OGA. To facilitate financing (providing that it is not a condition of the charge that the licence be assigned), the OGA's consent does not need to be obtained prior to the charge being granted provided that details of the charge are provided within ten days.

Joint Operating Agreements

To balance their risk, most E&P companies will hold licenses or interests in licenses in different oilfields and different stages of development. They also spread their expertise, cost and risk by joining together with other companies to apply for a license. Where there are multiple licensees, they are jointly and severally liable to the OGA for the performance of work and payment obligations under a license.

To regulate their joint venture, and allocate the costs, obligations and benefits between themselves, the parties will enter into a joint operating agreement (JOA). These tend to be based on modifications to a standard form produced by the industry group Oil & Gas UK but other industry groups such as the Association of International Petroleum Negotiators (AIPN) produce templates and some of the larger E&P companies produce their own.

Under a JOA, one party, usually that with the biggest interest in the joint venture is appointed as the 'operator', who then has full control of conducting and directing all operations in the contract area, under the confines of the JOA. The other parties are considered 'non-operators', who only retain indirect control of the operations in the contract area, such as voting on subsequent operations, electing whether to consent to subsequent operations, and certain inspection rights.

Restructuring issues

Under the terms of the JOA, the parties are usually responsible for contributing to the costs of the joint venture in proportion to their respective interest. If one party defaults under the terms of a JOA, the other parties will be required to make up that shortfall, and if the default is not remedied within a certain timeframe, there are various consequences which will need to be taken into account as part of any restructuring process. The defaulting party will lose their right to vote and the co-venturers will have the right to act without consulting the defaulting party, which may have the effect of imposing cost liabilities, so making the financial position even worse.

The most draconian consequence is that the defaulting party's interest in the joint venture may be forfeited. It is debatable whether or not the defaulting party can claim relief from forfeiture. The defaulting party will also loose the right to receive information and vote and accordingly decisions can be made without them during this period. Some JOAs provide for complete loss of production and interest in the JOA/license without value and others provide for pre-emptive rights for the non-defaulting parties with a valuation of the license based on the value of the oil reserve at standard rates in accordance with the Guidelines for Application of the Petroleum Resources Management System provided by the Society of Petroleum Engineers.

Because the anti-deprivation principle may invalidate these types of clauses and make them unenforceable, the oil and gas industry is not keen to test the matter in court and so the validity of this type of clause is uncertain. Instead, every effort needs to be made to avoid triggering the default provisions in the JOA. For further reading on the anti-deprivation principle, see Practice Notes: The pari passu principle and collection remedies for the office-holder and The difference between the anti-deprivation principle and the pari passu principle.

Jurisdictional issues

The UK is party to a number of international treaties which govern access to the continental shelf and regulate co-operation between member states in the area such as the 1958 Geneva Convention on the Continental Shelf, the 1982 United Nations Convention on the Law of the Sea, the OSPAR Convention and the Energy Charter Treaty.

As between E&P companies holding neighbouring licences, it is sometimes necessary for them to enter into cross-permit reservoir unitisation agreements. Unitisation occurs when licensees of oil and gas reserves pool their individual interests in return for an interest in the overall unit. It is then operated by a single company on behalf of the group. This happens when an oilfield lies under different licences held by separate E&P companies.

Insolvency analysis

OFS providers are more likely to suffer formal insolvency as they are being squeezed by the E&P companies cutting their costs. OFS providers might find themselves in market circumstances where they have no choice but to provide the discounts being demanded by the E&P companies on current contracts and may find that these are terminated or not renewed when they expire.

In practice, a distressed E&P company is more likely to be looking for debt reorganisation rather than formal insolvency. Even a Scheme of Arrangement is likely to trigger the termination clauses in E&P licenses and any JOA. Instead it would be looking to refinance its loans on better terms reflecting the lower oil prices or by debt restructuring by renegotiating the terms of the loan contract to avoid default.

Lenders and insolvency practitioners are unlikely to be keen to take control of a business in the oil and gas industry where the health and safety issues and environmental risks are potentiality catastrophic. Debtor in possession options are likely to be explored and persevered with for rather longer than in other industries, given these risks.

Because of the transfer restrictions and risk of termination of an E&P license on insolvency, it is essential to begin a dialogue with the OGA as early as possible in a restructuring. The OGA will want to understand the legal and practical implication of the financial problems and the implications for the work obligations and decommissioning costs.

One of the ways an E&P company can reduce costs and produce a revenue stream is to undertake a farm-out of part of its license interest in a field, in exchange for the incoming company agreeing to perform services (such as to pay for the drilling of a proposed well). Another option would entail disposing of the company's interest in an E&P license entirely to allow another company to extract the oil. In the current market willing buyers may be few, plus, this may be more difficult if the license is for a field which is only at the exploration stage with no proven reserves. Also in relation to possible (unexploited) reserves, the consent of the OGA is required for the sale or the grant of an interest in future production where consideration is paid in advance of extraction. It makes 'reserve-based lending' more difficult than asset-based lending in other industries.

Despite these difficulties, there have already been administrations of E&P companies, such as Iona Energy Company (UK) plc. So where should an insolvency practitioner start? A key priority before accepting an appointment is for the insolvency practitioner to initiate a dialogue with the OGA and the co-venturers under any JOAs to make sure that the licenses can be preserved and the JOA default provisions managed.

The insolvency practitioner needs to establish where is the centre of main interest (COMI) in the E&P company to identify whether it will be governed by English law. In this global sector, it is likely that many cross-border issues will need to be considered. An E&P company with a COMI in England may own foreign subsidiaries; it may hold licenses in assets outside of the UK or other contracts which may or may not be written under English law or subject to the jurisdiction of the English courts. Its assets such as equipment will be out on oil rigs in the middle of the sea and difficult and/or costly to locate, value and return to base so they will almost certainly be sold in situ.

Options available to officeholders

Upon administration, an insolvency practitioner will first of all need to try to rescue the E&P Company as a going concern in accordance with the statutory hierarchy of duties. There are a number of obstacles which the insolvency practitioner is likely to face in trying to achieve a sale on a going concern basis:

- In the UK, the Crown owns all the oil and gas in the ground and the license holder only has on interest in the oil and gas once it is extracted. Consequently the insolvent company's most significant asset is its licence to extract oil and gas. That licence may be revoked on insolvency of, at least, the operator, and the consent of the OGA is required to deal with the licence.
- Most licenses are exploited as part of a JOA. The insolvency practitioner would need to examine the terms of the JOA to see whether the co-venturers have any forfeiture rights to protect their own positions from having to fund the shortfall for the insolvent party. There may be pre-emptive rights which would require a valuation of the oil reserves on the industry-standard basis set by the Society of Petroleum Engineers (SPE).
- In respect of any NewCo purchasers, it is likely that the OGA will ask for a parent company guarantee in respect of the licence obligations.
- A purchaser will need to provide security for its share of the decommissioning costs (discussed below). This is usually by way of a letter of credit, a facility from a third-party financier or parent company guarantee.
- Tax relief is available in respect of decommissioning costs and will be critical in determining a purchasers' decision to invest.

If a sale cannot be achieved on a going concern basis, the operation may need to be closed down/decommissioned.

The UK has very strict decommissioning laws and as a consequence decommissioning costs are one of the most significant and unpredictable expenses of operating an offshore oil and gas license. In theory, the security provided in respect of the decommissioning costs when a license is granted should be sufficient to meet these costs, through:

- letters of credit and facility arrangements with third-party financiers
- the issue of bonds by a bank or institution with a certain minimum credit rating and
- contributions made by participants into a designated trust arrangement

The PA 1998 (as amended by the Energy Act 2008 (EnA 2008)) sets out the relevant decommissioning obligations. The obligations arise when the Secretary of State serves a 'Section 29 Notice' on the operator of the field and each of the licensees requiring them to submit a decommissioning programme setting out in detail the work which will be undertaken. Whilst in the first instance the Section 29 Notice will be served on those parties to the current JOA, a Section 29 Notice may also be served on previous licence holders and any parent or associated company of a licensee.

Although the OGA has in theory the power to impose liability for decommissioning in previous licensees and their associated companies but so far it has not chosen to exercise this power.

One category of participant that can also be served with a Section 29 Notice is 'a person ... who owns any interest in the installation otherwise than as security for a loan' (Section 30(1)(d)). The exception in this provision relates only to security for a loan and it appears that this section could catch a lender following enforcement of its security, as it would no longer have an interest 'as security for a loan', but would assume ownership itself.

References:

EnA 2008, s 30(1)(d)

The same may possibly also apply if the lender has control of a borrower as a result of covenants under a facility agreement or by the taking of equity in the borrower group or if a royalty or similar interest gives the lender a sufficient (economic) interest in an installation.

The decommissioning costs will be a significant issue in any formal insolvency. An insolvency practitioner will want to be satisfied that he is not taking on any risk of personal liability for environmental or health and safety breaches by the E&P company either before his appointment or during the administration period. He would no doubt want indemnities from the lender and to know that he would be able to get insurance and bonding before he agreed to act.

Any buyer wanting to acquire assets from the administrator of an E&P company would similarly want to understand the extent of liabilities for decommissioning and the extent to which these were adequately covered by the security provided since the license was granted.

With an increasingly mature basin, the amount the UK industry is expected to spend on decommissioning is expected to increase in the foreseeable future. In 2013, £1bn was spent on decommissioning and this is predicted to rise to £8bn in 2018.

References:

House of Commons Library Briefing Paper: UK offshore oil and gas industry—22 March 2016

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Susan Kelly leads the Restructuring & Insolvency practice group in the UK and Europe and is a member of our Global Board.

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