

Report proposes changes to UKCS regulation

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Late last year, Sir Ian Wood released “UKCS Maximizing Recovery Review: Interim Report” - a review commissioned by the UK Secretary of State for Energy and Climate Change to examine how the future economic recovery of oil and gas from the UK continental shelf (UKCS) can be improved. Although the UKCS remains a significant oil and gas producer, with estimates of between 12 and 24 Bboe remaining, production levels are declining, discoveries are becoming smaller, and development costs have increased significantly. Additionally, some UKCS infrastructure is operating at or beyond the end of its originally intended life. The report suggests that more regulatory oversight is required to address these challenges and encourage investment. Some of the most interesting recommendations from a legal perspective are as follows:

Creation of a new industry-funded regulator. The report suggests that the Department of Energy & Climate Change (DECC) has historically not had the necessary time or resources to play a sufficiently proactive role in UKCS operations. The report recommends the creation of a new regulator to be funded, as is Ofgem (the UK natural gas and electricity markets regulator), by an annual license fee paid by the companies that it regulates. It is not clear how a license fee would be allocated between companies operating in the UKCS. Ofgem allocates its license fee by reference to the number of customers a company has, but it is difficult to envisage a fair metric for a UKCS regulator. Size of acreage, production levels, and size of company all have obvious drawbacks.

Third-party access provisions. Many newer and smaller fields are not economic to develop unless access is granted to existing pipeline and processing facilities. Currently, third-party access to upstream infrastructure is governed by the Energy Act 2011, as supplemented by a voluntary Code on Access to Upstream Oil and Gas Assets on the UKCS developed by PILOT. Companies seeking access to infrastructure have the right to apply to the Secretary of State for a notice permitting such access if good faith negotiations with the owner have been

unsuccessful. Although the more informal negotiation procedures from the code are generally followed, only a small number of formal applications are made to the Secretary of State. This is due to a combination of (a) parties being reluctant to risk the uncertainty of the Secretary of State making a decision and instead prefer to accept the results of their negotiations (even if imperfect); and (b) companies’ perceptions that the DECC is inexperienced in dealing with access to infrastructure. The report recommends that E&P licenses must fully comply with the code, and enforcement of the code and resolution of disputes will be managed by the new regulator. It remains to be seen if any new regulator could be more effective in resolving access disputes, or if disputes could be resolved in a shorter period than the current 16-week estimate.

A new dispute resolution process. The report recommends that the new regulator should be given the power to resolve disputes between UKCS participants by making a recommendation, and that failure to comply could constitute a breach of the license (the ultimate sanction for which is revocation). It is not clear how this is intended to fit with the dispute resolution procedures in UKCS joint operating agreements, pipeline operating agreements, and unitization agreements. These agreements may need amending to provide that where the regulator has jurisdiction over a particular matter, contractual dispute resolution procedures may not be followed.

Generally, it is not clear that this is likely to improve current practice. Industry agreements commonly provide for expert resolution of technical disputes and for contractual disputes, arbitrators with significant experience of the energy industry are typically appointed. If the regulator will appoint individual experts or arbitrators to resolve particular disputes rather than the parties or a professional body, it is difficult to see how this is an improvement. However, if the regulator plans to try to resolve the disputes in-house, there remains a risk that it will struggle to find the necessary technical knowledge and capacity to offer a speedy and fair resolution to participants.

Simplification of UKCS negotiations. The report mentions that operators should be given a year to “come up with their solution

to simplify the complexity and significantly reduce the time required in UKCS commercial and legal negotiations” or face a regulator-imposed solution via new license terms. In order to implement any such imposed solution, new secondary legislation would need to be passed unilaterally amending the current UKCS licenses. Any decision to implement a solution by way of legislation could be subject to challenge in the courts, but grounds of application are narrow. It is possible that a party would establish grounds for a judicial review of the regulator’s decision based on the fact that the UKCS model clauses are rarely amended retrospectively and that to impose significant changes, rather than working with industry’s proposed solution, may unreasonably defeat industry participants’ legitimate expectation that their existing license terms will not change.

It is not clear how a framework could be implemented that would, in practice, reduce negotiation time and complexity. As the report mentions, standard form contracts do exist, but inevitably such contracts can only be used as a starting point and are amended to reflect individual transactions and standard company positions. If the use of standard contracts were to be mandatory, it is not clear how parties’ negotiation rights, and the scope of permitted amendments, could be limited or made subject to regulatory approval. This could add to the complexity of UKCS negotiations and even act as a disincentive to investment.

The final report, which will include detail on strategies for issues such as exploration, infrastructure and asset stewardship, will be published early this year. In the meantime, UKCS participants should consider working to develop proposals for key areas such as the simplification of UKCS contract negotiations in order to try to avoid any arbitrary (and potentially unworkable) solutions being imposed on the industry.

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