8 January 2016

By email: woodreviewimplementation@decc.gsi.gov.uk

DECC Consultation Co-ordinator
3 Whitehall Place
London SW1A 2AW
United Kingdom

Dear Sirs,

Maximising Economic Recovery of Offshore UK Petroleum: Draft Strategy for Consultation

We are pleased to provide our comments on the document entitled Maximising Economic Recovery of Offshore UK Petroleum: Draft Strategy for Consultation (the "Strategy").

A. About InfraShare Partners

Our firm is engaged in facilitating and implementing comprehensive, workable and sustainable solutions that enable the development and financing of shared-use infrastructure projects around the world. Accordingly, our comments focus on the significant challenges and opportunities related to UKCS infrastructure, by which we mean hubs and offshore pipelines. In providing these comments, we are acting independently and not on behalf of any third party. A copy of this letter has been published on our website (www.infra-share.org).

B. General Observations

The Strategy Should More Clearly Address the Challenges Facing the UKCS Today

The high level nature of the Strategy will, we believe, materially undermine its efficacy. DECC's rationale for adopting this approach is unsound, and we are concerned that this excellent (and in our view last) opportunity to achieve fundamental reform of the UKCS is being missed. **We urge DECC to reconsider its approach generally and, in particular, to incorporate detailed and legally-binding provisions for regulating UKCS infrastructure – including issues relating to access, decommissioning and greenfield development. This can be achieved quickly and efficiently by drawing on best international practice in comparable jurisdictions**, including the United States, Canada and Australia (amongst others).

Extensive experience globally has demonstrated clearly that critical "natural monopoly" infrastructure required for natural resource transportation/logistics will, in the absence of effective regulation, become a "battleground" on which private sector combatants employ "hardball", anti-competitive tactics to maximise their own commercial advantage. Invariably, this behaviour damages the interests of host nations. Clear evidence that this has occurred in the UKCS can be found throughout the Wood Review final report (see below). **Our research also shows that where critical infrastructure is owned or controlled by petroleum (or mining) companies as part of their "integrated" operations (which has for decades been the norm in the UKCS), then regulation must be detailed and robust in order to achieve positive outcomes. Regrettably, the Strategy does not come close to meeting this standard.**

We anticipate that DECC has, in its recent prior consultations with private sector UKCS participants, been strongly urged to adopt a strategy that is highly flexible and non-prescriptive. This is to be expected, particularly from owners of "natural monopoly" infrastructure who prefer to operate freely in a "light touch" regulatory environment. Indeed, this is exactly the approach that has applied in the UKCS since the 1980s, and it is largely responsible for the damaging behaviours highlighted by the Wood Review. Unfortunately, the vagueness of the Strategy simply mirrors that of existing UKCS "regulations", including long-standing DECC guidelines on resolution of third party access disputes and the related industry-led Infrastructure Code of Practice ("ICoP"). The Wood Review final report contains clear and actionable evidence of entrenched behaviours that are damaging the interests of the UK taxpayer. **The Strategy, as drafted, will do very little to improve the situation, nor move the UK closer to the OGA's objective of MER-UK.**

DECC may also have been warned that a "softly-softly" approach to implementing change in the UKCS is necessary to avoid "scaring away" potential investment. Perhaps counter-intuitively, firm and comprehensive measures from DECC and the OGA to address on-going market failures and provide regulatory certainty are exactly what is needed now to spur new investment. As an illustration of this, we note that pipelines in the United Sates are among the most heavily regulated in the world yet the sector has, over the last decade, seen extraordinary levels of new investment. Significant time, public expense and effort has gone into the Wood Review and related legislative changes. **It would, in our view, be a tragic mistake if DECC and the OGA were now to shy away from implementing fundamental reform in response to the protests of private sector participants whose entrenched positions and vested interests are, in many cases, at root of the UKCS's curent problems.**

DECC states that the Strategy "is purposefully high level, so that it can be applied to any material situation which may occur in the UKCS at any stage of the business cycle". There is no need for this to be the case. The Petroleum Act 1998 (as amended by the Infrastructure Act 2015) contains provision for the Secretary of State to produce a new strategy or revise a current strategy whenever he thinks appropriate (section 9F). Accordingly, it can be changed when and if economic or other conditions change. **The Strategy needs to address the serious and immediate challenges facing the UKCS today, which some commentators have suggested could lead to the basin's near-term and irreversible collapse.**

DECC enthuses that the Strategy "provides reasonable space for the OGA to determine, in the light of the facts of any specific situation it encounters, how best to proceed". This implies that the OGA will, in effect, make up the rules on a case-by-case basis as it goes along. Such an approach is not conducive to new investment in the UKCS, which requires comprehensive regulatory certainty to support informed commercial decisions. Lack of certainty will also lead to a proliferation of disputes, due to the inability of private sector participants to predict the outcome of engagement with the OGA. In any event, it will take the OGA many years (if not decades) for an "iterative" approach to achieve an appropriate level of regulatory certainty (as it did FERC in the 1980s and 1990s). The UKCS does not have the luxury of time. Finally, prior to achieving regulatory certainty the OGA will find itself restricted in its ability to use its new powers due to its failure to provide clear prior guidance, and any attempts by the OGA to use its new powers aggressively are likely to face legal challenges that, in many cases, will be well-grounded[1]. The net result will be that **behaviours in the short term are unlikely to change in the UKCS, which will retain its reputation as "one of the most difficult and adversarial legal and commercial basins in the world"**[2].

DECC and OGA Should Prioritise Reforming the Regulation of UKCS Infrastructure

The UKCS is under pressure due to a variety of adverse factors, which can be grouped as follows:

1. External factors, such as commodity prices, which are outside the control of private sector participants in the UKCS and DECC/the OGA;

[1] The planned "sector specific" strategies and "OGA plans" will not be legally binding and, therefore, are unlikely to be effective. Global experience shows that major natural resource companies commonly resist and/or seek to avoid any infrastructure regulation that is not detailed, robust and legally-enforceable.

[2] See Wood Review final report, page 27.

2. UKCS-specific factors, such as high operating costs, which can be remedied by private sector UKCS participants whose interests in doing so are largely aligned with those of the UK taxpayer; and

3. UKCS-specific factors, such as infrastructure-related access costs, disputes and conflicts of interest, which are: historic, structural and often caused by market failures; cannot be resolved by UKCS private sector participants in a timely manner; and must therefore be addressed through regulatory action.

DECC and OGA should be focusing on matters falling in paragraph 3 above, especially where prompt regulatory intervention could have a positive short term impact on UKCS petroleum recoveries (see Table 1 below).

Table 1
Challenges Currently Facing the UKCS

		Ability of DECC and OGA to resolve / mitigate	
		Low	High
Short term impact on achieving Principal Objective (MER-UK)	High	- Low oil and gas prices - Unhelpful and inflexible UK fiscal regime - Lack of vehicle for direct state investment / support - Relatively high operating costs - Inefficient utilisation of infrastructure - Lack of access to capital - Strong GBP	- Infrastructure access tariffs that impose unfair share of operating and capital costs on users - Lack of transparency re: infrastructure (technical, commercial terms and operational matters) - Restrictive terms and conditions applicable to existing infrastructure - Premature decommissioning of existing infrastructure - Conflicts of interest arising from "integrated ownership" of upstream and infrastructure
	Low	- Lack of technological innovation - Lack of new discoveries	- Need for development of regional infrastructure solutions - Lack of investment in exploration - High regulatory burden

UKCS infrastructure is, in our view, the one area where DECC and the OGA can and should have a very meaningful short-term impact. They should not hesitate to move aggressively to address market failures and provide clarity in order to improve the economics for existing producers and encourage investment in new exploration and development. As the Wood Review noted in its final report: "the UKCS benefits from an extensive coverage of infrastructure which potentially offers a competitive advantage, allowing new fields to be developed more cheaply via existing infrastructure, and enabling smaller fields to be developed which would otherwise be uneconomic if developed on a standalone basis" (page 45). **DECC and the OGA must now act in the UK national interest to ensure that the UKCS's potential infrastructure advantage is realised.**

An Overhaul of UKCS Infrastructure Regulation is Urgently Needed

The UKCS is in deep crisis, and its very future is at risk. Unless prompt and effective action is taken by all relevant stakeholders, including DECC and OGA, the basin faces a potentially irreversible collapse. This could, we fear, occur in the following manner[3]:

- individual wells are prematurely shut-in by producers due to unnecessarily high operating costs associated with access/use of critical hub and pipeline infrastructure, which leads to

[3] The OGA outlined a similar scenario in its *Call to Action* (25 February 2015) noting that "[t]he economic challenges of profitably maintaining ageing infrastructure may lead companies to cease investment in some activities. A consequence of this includes accelerated production decline, reduction in overall production volumes and increases in costs, all of which could lead to premature decommissioning. As each platform is decommissioned, shared infrastructure costs have to be allocated across fewer platforms increasing the unit operating costs in a vicious circle." (page 25)

- an increase in the already-excessive unit access/use costs of such infrastructure for the remaining producers that rely on it, which then results in

- a "domino effect" in which more and more producers relying on such infrastructure shut-in their production in the face of ever-increasing unit access/use infrastructure costs, following which

- there are then too few remaining users of the infrastructure to support it even if costs were fairly determined and allocated, which forces

- the "premature"[4] decommissioning of the infrastructure that (due to the maturity of the UKCS) can never be replaced or re-commissioned.

To prevent an unnecessary collapse driven by existing "market failures", DECC and the OGA should urgently consider and draw from the approaches to infrastructure ownership, access and development in other countries and incorporate regulatory solutions where appropriate. Some of these are discussed below.

The Wood Review canvassed briefly the approaches employed in Norway and the Netherlands for the regulation and ownership of their offshore infrastructure. These situations are, we believe, certainly worth consideration – although they must be seen in the context of structural differences, including the important role played by state-owned oil companies (such as Statoil). These entitles hold major equity participations in most upstream developments and can, through use of joint venture channels, encourage and enforce private sector behaviour that is consistent with the national interest. No such subtle enforcement mechanism exists in the UKCS, which may help to explain why infrastructure challenges are much more severe in the UKCS than they are in Norway and the Netherlands.

Despite the strong influence of state-owned entities, both Norway and the Netherlands have still seen fit to adopt measures to:

- achieve structural separation of infrastructure and upstream assets, in order to reduce conflicts of interest; and

- retain firm regulatory control over tariffs for access to and use of critical infrastructure.

The Wood Review final report notes that "the Dutch Government is an active owner of infrastructure and regulates the industry in a more active manner [than does the UK], facilitating a degree of transparency, fairness and an enhanced information flow which makes resolving disputes easier and achieves consistency across the region" (see page 43). The report also points out that the Netherlands has a number of infrastructure companies whose business model is solely to operate offshore pipeline (and onshore processing facilities) and, therefore, actively seek to attract new transport business and operate "outside the ring fence" (page 46). The Wood Review found that "third party access to infrastructure is not an issue in the Netherlands".

In Norway, the Ministry of Petroleum and Energy (the "MPE") controls the transport of gas from well to markets. Gassled owns the offshore gas pipeline infrastructure, and operates pursuant to licences granted by the MPE to transport gas. Gassled's pipeline system is operated by Gassco AS, which is an independent state-owned company. Gas transportation tariffs have been regulated by the MPE since 2002, when Gassled was first established. In 2013, the MPE (somewhat controversially) reduced the tariffs by approximately 90% for the period from 2016 to 2028.[5] In justifying its actions, the government argued that lower transportation tariffs

[4] The decommissioning is "premature" not because it isn't economically rational at the time the decision is taken, but because if earlier "market failures" that led to well shut-ins had been addressed through regulatory intervention then the economic case for decommissioning would not have arisen. For a variety of complex reasons, there is generally little prospect for market incentives to avoid this type of scenario, which can perhaps be characterised as a "reverse tragedy of the commons". Avoiding such tragedies invariably requires strong regulatory intervention.

[5] See CMS Law-Now: Oil and Gas: Litigation in Norway over Tariffs for the Transport of Gas, 3 November 2015 at http://www.cms-lawnow.com/ealerts/2015/11/oil-and-gas-litigation-in-norway-over-tariffs-for-the-transport-of-gas?cc_lang=en

would "result in lower costs and contribute to recovering a larger part of the socio-economically profitable petroleum resources". While we do no condone the manner in which this change was implemented, which will adversely affect Norway's ability to attract new infrastructure investment, this example serves to illustrate (a) the degree of control that is exercised by the MPE over offshore infrastructure access in Norway, and (b) the direct and important connection between infrastructure access costs and upstream production and exploration activity[6].

In the United States and Canada, FERC and the National Energy Board, respectively, exert significant regulatory control over most inter-state/provincial and offshore pipeline infrastructure. Access pricing is subject to strict economic regulation, which prevents infrastructure owners from earning returns that exceed their permitted costs plus a reasonable return on capital. Development of infrastructure is organized through formal and transparent "open season" procedures, which promote commercial fairness, efficient routing/sizing, and highly "bankable" contractual arrangements. FERC and NEB have established, over an extended period, an extensive "rule book" that provides infrastructure owners and users with a high degree of certainty. The petroleum sectors in both countries closely resemble the United Kingdom, with strong emphasis on private sector involvement. It is significant, however, that both countries have achieved an outcome under which critical infrastructure is largely owned and operated by private, independent pipeline companies (e.g., Kinder Morgan, Energy Transfer Partners, TransCanada Corporation and Enbridge). The benefits of this situation include lower infrastructure costs (as the pipeline operators have a lower cost of capital/hurdle rate) and fewer conflicts of interest.

Due to its large land mass and abundant natural resource wealth, Australia has wrestled with a variety of challenges associated with the sharing of infrastructure used for transporting natural resources, including iron ore, coal, bauxite, oil and gas. While the details of the Australian experience are beyond the scope of this letter, DECC and the OGA should be aware that there have been many important "lessons learned" in Australia over the past 20 years. In particular, these have shown (a) just how far natural resource companies will go resist regulatory changes affecting the use or economics of their infrastructure, (b) the difficulties associated with "retro-fitting" infrastructure access regulation in the case of established integrated operations, (c) the importance of transparency of information to a workable infrastructure access regime, and (d) the ways in which effective control of natural monopoly infrastructure by one firm can enable it to control the pace of development and/or seek to capture the value of other natural resources that are "serviced" by its infrastructure.

We would be pleased to share further information on the Australian experience, and other global experience, with DECC and the OGA should this be of interest.

The experiences in Norway, the Netherlands, the United States, Canada and Australia all stand in stark contrast to the approach taken in the UKCS, where infrastructure is largely owned and controlled by the oil majors (Shell, BP, ExxonMobil, etc.) and has, since the 1980s, operated under a "light touch" regulatory regime (much of which has been developed by industry participants themselves). Based on our experience with international regulatory models, it is clear that the market structure and regulatory environment in the UKCS, which has not been fundamentally reformed since the 1980s, is inconsistent with best practice[7]. **If the Strategy is implemented as currently drafted, we do not expect this situation to change materially.**

Wood Review – Infrastructure-Related Challenges, Observations and Recommendations

It is important to recall some of the challenges identified by the Wood Review relating to UKCS infrastructure - the full scale of which is truly staggering – as well some associated recommendations contained in the final report:

6 The Wood Review agreed, noting that "infrastructure tariffs for third party business, if they are too high, increase development costs and shorten the commercial life of late-life fields" (see page 46).

7 Although some limited progress has recently been made towards "unbundling", including Antin's recent acquisition of a controlling stake in CATS), progress will continue to be painfully slow in the absence of a detailed regulatory framework that encourages such outcomes.

Challenges and Observations:

Infrastructure Access Disputes and Tariffs

- **UKCS infrastructure, both managing ageing assets and securing the necessary investment in new assets, is perhaps the UKCS's most significant Achilles heel** (page25);

- **the fundamental problem is a misalignment of commercial and technical interests between the owner of the hub platform and infrastructure and the party seeking access to process and transport their well stream** (page 45);

- the frequency of failure to agree between and within consortia on key issues, including access to infrastructure and development of field clusters has been very damaging (page 25);

- the small operator seeking access has little bargaining power and often suffers interminable delays in trying to counter "risk issues" raised by the infrastructure owner (page 45);

- there have been a significant number of disputes and disagreements on commercial and technical issues, mainly on access to processing and transport infrastructure and new field cluster development (page 22);

- many UKCS fields are marginal and very inter-dependent, and there is competition for ageing infrastructure (pages 1 and 15);

- there is a need to maximise access to existing infrastructure in the Southern North Sea to open up stranded reserves (page 42);

- third party access to infrastructure is […] clearly [an issue] in the UK with some operators being exemplars but others apparently unwilling to accepting new tariff business at competitive rates (page 43);

Infrastructure Decommissioning

- infrastructure in mature areas of the North Sea is under increasing commercial pressure as maintenance costs increase and throughput diminishes (page 45);

- between 500,000,000 and 2,000,000,000 boe may be at risk from the early decommissioning of existing infrastructure (page 45);

- there is a need to ensure that the life of existing infrastructure is prolonged to facilitate the processing, transport and export of the UK's offshore oil and gas resources, and investment in new key infrastructure is achieved (page 16);

- a key market and timing consideration is the need to maintain ageing infrastructure and encourage new infrastructure investment, as well as ensuring it is fully utilised through appropriate collaboration (page 12);

New Infrastructure Investment

- new infrastructure is typically designed only for specific developments and without taking account of wider potential demand (page 13);

- despite a lot of discussion on co-ordinating the development of a number of fields, little collaboration has yet been achieved in terms of field and infrastructure development (page 25);

- both exploration and field development are being badly affected by a lack of anticipated infrastructure availability (page 26);

- the pace of new developments is being constrained in part by the inability of third parties to negotiate appropriate technical and commercial terms to achieve access to existing infrastructure; as a result, developments are taking longer to implement and often end up being sub-optimal (page 45); and

- interviewees suggested looking at end-of-life fiscal plans to encourage business models which retain essential infrastructure, and combine late-life operations and decommissioning (page 19).

Recommendations:

Infrastructure Access Disputes and Tariffs

- **the OGA must achieve "significantly better collaboration" concerning UKCS infrastructure** (page25);

- **the OGA should consider measures to encourage infrastructure owners to offer more competitive tariffs in order to improve marginal field economics and reduce tie-back costs** (page 46);

- **UKCS infrastructure "tariff business" should not be treated as a high margin activity** (page 46);

- infrastructure owners should make their infrastructure available, subject to their own capacity requirements and technical compatibility, at fair and economic commercial terms and rates to potential third party users (page 16);

- the OGA should make full use of its legal powers to resolve disputes and facilitate access to infrastructure, including DECC's long established, but little used, powers (page 46);

- it is essential that all parties can gain access to the UKCS's extensive infrastructure on an appropriate commercial basis (page 45);

- owners should be expected to demonstrate effective utilisation of infrastructure (page 22);

- operators must be held to account for the proper stewardship of their assets and infrastructure consistent with their obligations to maximise economic recovery from the fields under their licences and with consideration to adjacent resources (page 16);

- **measures should be taken to encourage a new infrastructure model focused on joint funding of infrastructure, and also the independent transporting and processing of third party production** (page 26);

- there is a case to encourage specialist transport and processing companies assuming responsibility for operation UKCS infrastructure (page 46);

- **the Dutch infrastructure business model should be considered for the UK, potentially for both new infrastructure and existing infrastructure where it could be unbundled from the existing production hubs**; under such an "unbundled" model, the transporter would solely concentrate on the timely and efficient transportation of hydrocarbons, and no longer face conflicts of interest (page 46);

- the ability to unbundle infrastructure from the existing production centric hubs should be evaluated and the revenue and decommissioning fiscal implications of such a development need to be considered (page 26);

Infrastructure Decommissioning

- the OGA should ensure assets are not prematurely decommissioned, making the necessary linkage between decommissioning and access to infrastructure (page 52);

- the OGA should identify critical infrastructure, monitor its capacity, track current throughput and potential volumes within its catchment area, and be cognisant of the commercial drivers needed to sustain such infrastructure (page 44);

New Infrastructure Investment

- the OGA should support regional development of the UKCS, ensuring appropriate access to third parties and facilitating the development of new strategic infrastructure (page 20); and

- the OGA should facilitate and encourage collaboration on cluster field development and use of infrastructure to maximise the amount of oil and gas discovered and recovered (page 15).

The Wood Review noted that the current rate of exploration drilling is totally inadequate to exploit the undiscovered potential of the UKCS within the lifespan of existing infrastructure. Given the scale of issues and challenges related to UKCS infrastructure identified in the Wood Review, we would submit that **there is a strong connection between (a) large numbers of existing and prospective operators and developers being unable to access infrastructure on clear, fair, and long term stable economic and commercial terms, on the one hand, and (b) low levels of investment in exploration and development relative to other basins[8].** The situation has, since delivery of the Wood Review report, been exacerbated by the declining oil price which is increasingly rendering higher cost alternatives to pipeline access (e.g., FPSO) uneconomic.

Based on the foregoing, it is clear (to us at least) that the light touch approach to regulating UKCS infrastructure, which has applied since the 1980s is simply not fit for purpose[9]. **The Strategy represents an excellent (and in our view the last) opportunity for DECC and the OGA to correct and, where possible, remedy past regulatory failings in the UKCS.**

The interests of the UK taxpayer demand an urgent and fundamental overhaul.

C. Answers to Specific Questions

DECC has requested comments on the following specific questions:

QUESTION NO. 1 - Do the MER UK Strategy Obligations, as drafted, adequately encompass the full range of actions and behaviours required of all the parties which they bind to deliver MER UK? If not, what is missing?

Overview

The Strategy Obligations do not adequately encompass the full range of actions and behaviours required of all the parties that they bind[10]. Section 9C of the Petroleum Act 1998 (inserted by Section 41 of the Infrastructure Act 2015) requires that actions be in accordance with the Strategy when:

- the holder of a petroleum license is "planning and carrying out activities as the license holder"

[8] For a discussion of the relationship between the willingness of natural resource companies to invest in exploration and "infrastructure risk", see: Paul Collier and Glen Ireland, Shared-use mining infrastructure: why it matters, and how to achieve it by at http://www.bsg.ox.ac.uk/research/working-paper-series/working-paper-009.

[9] That DECC Guidance and the Infrastructure Code of Practice have singularly failed to correct behaviours and achieve outcomes consistent with the Principal Objective is illustrated by the fact that there have only ever been 5 referrals of third party access disputes to the Secretary of State and only one formal notice of decision has ever been issued. If the existing regulatory framework was working properly, then one would have expected (in light of the issues identified by the Wood Review) a large number of appeals to the Secretary of State.

[10] As noted elsewhere in these comments, we question whether any of the actions and behaviours mandated by the Strategy, as drafted, can seriously be regarded as "binding".

- the operator under a petroleum license is "planning and carrying out activities as the operator"
- the owner of upstream petroleum infrastructure is "planning and carrying out the person's activities as the owner of upstream petroleum infrastructure (including the development, construction, deployment and use of the infrastructure)"
- "planning and carrying out the commissioning of upstream petroleum infrastructure"

What Does "Planning and Carrying Out Activities" Comprise?

The Act is unclear, and the Strategy should clarify, whether and to what extent the following are encompassed within "planning and carrying out activities" in Section 9C:

1. Exercise and enforcement of existing contractual rights: When a relevant party seeks to exercise rights and/or privileges, or enforce obligations, under existing contracts (e.g., the right of an infrastructure owner to switch to a "cost sharing" arrangement), is it required to do so in a manner consistent with the Central Obligation? There is no reason why the term "carrying out activities" could not include these types of activities and if they are not included then relevant parties will, we believe, shelter behind existing contractual arrangements. Many of these were entered into in dramatically different commercial circumstances or, in the case of third party access arrangements, following one-sided negotiations.

   Paragraph 31 of the Strategy, which deals with this issue, appears to shy away from interpreting the Infrastructure Act in this way and, at the same time, creates uncertainty. For example, it states:

   - "Neither this Strategy, nor any other legal instrument, confers powers on the OGA which would allow it to intervene directly in private contracts" - What is meant here by "intervention" and does this include sanctioning a private party for exercising its contractual rights in a manner contrary to the Principal Objective? Does DECC consider that OGA has no ability to regulate infrastructure access tariffs in the UKCS if and to the extent they are covered by contracts? What about situations where existing contractual terms have arisen due to historical market failures?

   - "It may occasionally be the case that the OGA will find that a relevant person's contractual provisions place that person, or could place that person, in breach of the Strategy." What is meant by "occasionally" and when would this happen? The lack of regulatory certainty created by this sentence may discourage investment in the UKCS.

   - "In these cases, the OGA will explore the matter further with the persons concerned in the manner described above." What is meant by "explore"? Does this imply that any resolution will be consensual?

   - "It may be that, occasionally, the OGA will need to assert its right as a regulator to use its sanctions where a relevant person fails to avoid a breach of its MER responsibilities through continued reliance on contractual provisions which conflict with the Strategy." What is meant by "continued reliance" here? Will the OGA only take action when a party is continually acting in a way that is contrary to the Principal Objective? How many times must it do this before the OGA will act? Again, the lack of regulatory certainty here is likely to be damaging.

   - "However, it will always be for the relevant person to decide for itself how to deal with that in terms of its contracts." It is very unclear what this is intended to mean, or how this relates to the foregoing statements.

As drafted, paragraph 31 seems to be saying at least three different things at the same time. DECC needs to decide whether respect for private contracts is more or less important than achieving the Principal Objective. In our view, there is clear statutory authority for intervention, as well as a strong theoretical basis based on past "market failures" and radically changed commercial circumstances. **If existing (and in many cases flawed, out-dated or demonstrably unfair) contractual provisions are permitted to take precedence over the Central Obligation, then it is highly likely the Principal Objective will never be met.**[11]

2. Openness and transparency in negotiations: When a UKCS participant is a party to negotiations and/or involved in a dispute (e.g., related to third party access to UKCS infrastructure), is it obliged to be open and transparent in its dealings with other private sector parties as well as the OGA? If it is, then this must be expressly stated. The recent Howe/Nelson third party access dispute[12] is a disturbing (post-Wood Review) illustration of how UKCS participants are not always open and transparent with competitors or, at least in that instance, even the OGA. Full and early transparency of all relevant information (e.g., concerning remaining infrastructure capacity, remaining asset life, technical specifications, etc.) is vitally important in the context of (a) third party access to infrastructure and (b) the planning and designing of new infrastructure. In the absence of a clear obligation of openness and transparency, such as has been effectively developed in Australia and certain other jurisdictions, infrastructure owners will invariably use their inherent information advantage to achieve commercial advantage over access-seekers. **The current approach to transparency in the UKCS is deeply flawed, providing too little information far too late in the process; in the absence of reform, this will continue to undermine achievement of the Principal Objective.**

3. Permitting step-ins, and competitive bidding: When a relevant party is considering works (e.g., a bypass to undersea pipeline infrastructure that is required by the decommissioning of a hub) the cost of which will be borne, in whole or in large part, by third parties, is it required to permit such third parties (or their agents) to step-in and undertake this work directly or, alternatively, in the event of project delays or cost overruns? Also, is the relevant party obliged to conduct a competitive bidding procedure that is fully transparent? In the absence of step-in rights and/or competitive bidding, there can be no assurance that owners of infrastructure (for example) are undertaking works in a timely, efficient and/or cost-effective manner. In such a case, the Principal Objective will almost certainly not be achieved.

4. Public "open seasons": When a relevant party is considering the design and construction of upstream petroleum infrastructure, is it required to launch a public "open season" process to ensure that all potential users of the proposed infrastructure are identified and accommodated to the extent practicable? Such processes are recognised as encouraging fair and collaborative outcomes when new pipeline infrastructure is constructed, and are required in the United States (by FERC), Canada (by the NEB) and other regulatory environments that are generally considered to be "best-in-class".

5. Conflict of interest: When a relevant party is exercising its voting rights or engaged in a negotiation with a third party in circumstances where it has a clear conflict of interest, is it required to abstain from voting or delegate its decision making and/or negotiation to a relevant party that is not conflicted and/or an independent expert? Conflicts of interest come up routinely in the UKCS, given the complex ownership structures involved (see the Howe/Nelson third party access dispute, for example). The Strategy must address this issue directly, if the Principal Objective is to be achieved.

[11] DECC and the OGA should not shy away from dealing with this complex but important issue, which has been successfully addressed by other regulators around the world in similar contexts. For example, FERC found that its efforts to deregulate energy markets in the United States in the 1980s were being undermined by existing, long-term "take-or-pay" contracts. FERC developed a creative and successful regulatory solution that created a strong inducement for, but did not require, private sector parties to renegotiate the terms of the offending contracts. A similar approach could be contemplated in the UKCS.

[12] See: https://www.gov.uk/guidance/oil-and-gas-infrastructure

QUESTION NO. 2 - Is there anything in the draft Strategy which should not be included? If so, why not?

Potential for Abuse of Safeguards

We consider that the manner in which the Strategy provides "Safeguards" risks rendering the Strategy completely ineffective. It seems clear (see Part 2, paragraph 38, and Part 3, paragraphs 4 and 27) that where a conflict arises between the Central Obligation or other behaviours required by the Strategy, on the one hand, and the Safeguards, on the other hand, the Safeguards take priority. We note that there is no statutory requirement for the Safeguards, which we expect will be relied upon extensively by private sector participants to continue acting/behaving in ways that further their private commercial interests, including when this undermines achievement of the Principal Objective.

Specific Concerns Regarding Safeguards

i. Safeguard in Paragraph 2 - No conflict with legislation: This Safeguard effectively subordinates the entire Strategy, which is intended to have the force of law, to all other UK legislation. This is, we believe, unnecessary and is inconsistent with the intent of the Infrastructure Act 2015. While we accept and agree that compliance with the Strategy should not override environmental or health and safety standards, DECC and OGA should be cautious about extending this exception to all other legislation. Reliance by relevant parties on competition legislation (for example) will, we anticipate, prevent the degree of transparency and openness necessary for effective collaboration in the UKCS and, ultimately, prevent the achievement of the Principal Objective.

ii. Safeguard in Paragraph 3 – Satisfactory expected return: This Safeguard states that no obligation imposed by the Strategy "requires any person to make an investment or fund activity where they will not make a satisfactory expected commercial return on that investment or activity". Whilst we agree that new capital investment should not be required by the Strategy if no reasonable investor would be prepared to make the investment, this Safeguard raises a number of issues relating to (a) interpretation, (b) existing "sunk" investments and (c) new investments. These are discussed below:

- Interpretation: the text of this Safeguard (which is drafted differently than the "guiding principle" in paragraph "d"[13]) raises a number of questions and creates uncertainties, which will be exploited by relevant parties to prioritise their own commercial interests over achievement of the Principal Objective. For example:

    - The words "where they will not make" appear to imply a degree of certainty that does not exist in the context of most investments in the petroleum sector; is this the intent?

    - When is a return "satisfactory"? It is worth noting here that infrastructure assets generally have expected levels of return (<5% in the current environment) that are much lower than those normally associated with upstream or midstream assets (typically 12-15+%). **The ownership and operation of critical UKCS infrastructure by major integrated oil companies, with their high expected levels of return, has contributed to high UKCS infrastructure tariffs and inefficient investment outcomes.**

    - Who decides when a return is satisfactory? If this is simply left to the subjective judgment of private sector participants in the UKCS, then they will simply manipulate investment assumptions in order to justify their action/inaction, including those relating to: capital expenditure, operating expenditure, risk premium, capital structure,

[13] Paragraph "d." states: "Compliance with the Strategy should not lead to any individual company investing in a project or operating existing assets where there is not a satisfactory expected commercial return on that investment. A satisfactory return does not necessarily mean a return commensurate with the overall corporate return on their portfolio of investment, e.g. a low risk investment could give low returns".

commodity price, inflation and throughput assumptions. This would render the Strategy virtually meaningless, and would represent a major regulatory failure by DECC and the OGA. Standards of reasonableness should, at the very least, be incorporated into the test, and all private sector judgments should be capable of review by the OGA (which should have the power to retain independent expert advice as needed).

  - Is a "satisfactory commercial return" different from a "commercial return" and, if so, how?
  - Can the same party legitimately apply different assumptions as to commodity prices or discount rates to different investments, or must they be consistent?
  - Can different parties legitimately apply their own unique assumptions as to commodity prices?

- Existing "sunk" investments: Consider the situation where the owner of existing UKCS infrastructure proposes to proceed with decommissioning and, in OGA's opinion, such action could prevent future development and recovery of UKCS petroleum. The Strategy, including the Central Obligation, could be read to require such an owner to keep its infrastructure in place thereby enabling future petroleum recoveries. However, this may require the owner to incur on-going operating expenditures and maintenance capital expenditures to sustain the asset and comply with health, safety, environmental protection and other applicable legislation, for which there may be no obvious or immediate commercial return. In such circumstances, the owner will argue that this Safeguard overrides the Central Obligation, and that it is entitled to proceed with decommissioning. How do DECC and the OGA intend to deal with such situations?

- New investments: Consider the situation where a petroleum company owns infrastructure facilities that need to be expanded or improved in order to accommodate the development and recovery of new, marginal petroleum resources. If the owner concludes that such investment is not justified, can it rely on this Safeguard even if a third party stands ready, willing and able to enable investment with a commitment to pay appropriate tariffs over a period of time sufficient to provide a reasonable return?

iii. Safeguard in Paragraph 4 – "OGA will discuss": This Safeguard states that "where in the opinion of a relevant person, the commercial return required by that person is higher than what is offered by a specific project which is required for the fulfilment of this Strategy and that person is therefore minded not to undertake that project, the OGA will discuss that with the relevant person before taking any further action". This may be read as an attempt to deal with the issue discussed in the immediately preceding paragraph. However, there are a least two problems with the Safeguard. First, this is not actually a Safeguard so much as a limitation on application of the Safeguard in paragraph 3 – this needs to be made clear. Secondly, the words "where in the opinion of a relevant person, the commercial return required by that person" reinforce our concerns that the Safeguard in paragraph 3 allows for a subjective, rather than an objective, test. Moreover, the fact that the OGA will "discuss" the situation does not appear to limit a relevant party's ability to rely on paragraph 3. Furthermore, the Strategy provides no clarity on how the OGA will determine whether the original concern raised by the "relevant person" is valid or not. Accordingly, UKCS participants seeking to rely on this Safeguard will in any discussions with the OGA retain the upper hand, based on inherent information asymmetry and their ability to "bog down" the OGA for months/years with masses of technical, financial and other analysis.

iv. Safeguard in Paragraph 5 – Long term investor confidence: This Safeguard provides that "no obligation imposed by or under this Strategy requires any conduct (including investment or other expenditure) where the benefits to the UK deriving from that conduct are outweighed by the damage to the long term confidence of investors in oil and gas exploration and production projects in relevant UK waters". As drafted, this Safeguard, opens the door for relevant parties to easily delay or simply avoid compliance with the Central Obligation and/or other obligations in the Strategy based on their claims of what would damage investor confidence. Such arguments could be used to resist (among other things) any effort to:

- constrain the exercise or enforcement of private contractual rights;
- require allocation of capital to investments;
- require divestiture of assets; and
- depart from the strict terms and conditions set out in existing petroleum licenses.

As constructed, this Safeguard also plays clearly into the hands of global petroleum companies, which can seek to bring in information from their wider operations that will be virtually impossible for the OGA to verify.

The Safeguard should, in our view, be eliminated. As an alternative, we would certainly have no objection if the OGA were obliged to take any action or decision under the Strategy only after it has, as regulator, considered a range of factors including the extent to which such action or decision may damage long-term investor confidence in the UKCS. This would allow affected parties to challenge the OGA on narrow judicial review grounds, which is entirely appropriate. However, private UKCS participants must not be able to justify behaviour that damages the UK national interest and/or avoid compliance with the Central Obligation based on nebulous claims about "investor confidence".

Potential Uncertainty Created by High Level Principles

It is unclear whether the statement of principles at the beginning of the Strategy is intended to inform interpretation of the obligations contained in the balance of the document. As drafted, relevant parties are likely to rely upon these principles to justify behaviours that are inconsistent with achievement of the Principal Objective.

Specific Concerns Regarding High Level Principles

Our specific concerns with the high level principles are discussed below:

a. High level principle "a": The principle states that **"all stakeholders should be obliged to maximise the expected net value of petroleum produced from relevant UK waters, not the volume expected to be produced"**. This principle lacks clarity and, in any event, must be reconciled carefully with the statutory MER-UK test (including any changes to it implemented through the Energy Bill). It is not clear that Parliament intended that the OGA should be working to (a) maximise the aggregate gross margins of companies operating in the UKCS (which seems to be the implication of principle "a", as drafted), as opposed to (b) maximising the total barrels of petroleum that can be economically recovered from the UKCS. Although it may be tempting to focus on net profits to the private sector, this approach potentially ignores the wider UK public interest which incorporates a range of benefits many of which may correlate more strongly with barrels of production than private sector margins, including the UK government's royalty receipts, employment levels nationally and in Scotland, the multiplier effect associated with local supply chains, etc. Moreover, there may be a case for focusing on volumes in order to extend the life of the UKCS (and avoid irreversible decommissioning of infrastructure), as this approach could maximise the "option value" of the basin. The UKCS contains significant petroleum resources that are uneconomic at current and anticipated near-term price levels. The likelihood of these someday becoming economic is greater the longer UKCS infrastructure can be kept in place.

There is scant evidence in the Strategy that DECC and the OGA have considered prioritising these wider benefits over the narrow interests of current private sector participants in the UKCS, which seem (wrongly in our view) to be taken as a proxy for the UK national interest. Such participants are, quite fairly, motivated largely by short-term profits and indeed many are actively exiting their positions in the UKCS. The UKCS has suffered terribly from short-term private sector behaviours, as the Wood Review clearly attests. **DECC and the OGA have a clear statutory mandate to manage the UKCS in the interests of the UK taxpayer; this guiding principle raises questions as to whether they are prepared to prioritise the UK national interest over short term profits of the petroleum companies.**

b. <u>High level principle "b"</u>: This principle suggests that the Strategy is seeking "investment and operational activities that, on an expected basis, add net value overall to the UK". This principle seems more closely aligned with the UK national interest, but may conflict with principle "a" as drafted (rendering the Strategy's commentary on the meaning of MER-UK unintelligible). As a drafting matter, DECC should where possible avoid vague and/or superfluous "overlays" on the statutory MER-UK test that may simply create confusion and lead to disputes and litigation.

c. <u>High level principle "c"</u>: This principle states that individual companies may need "to reallocate value between them, matching risk to reward" but that "the net result should deliver greater value overall". The references to "value" here are confusing, and the intent of this paragraph is unclear. Value to whom - private sector participants in the UKCS or the UK taxpayer? Moreover, the statement that not all "companies will always be individually better off" under the Strategy may, if not clarified, discourage new investment in the UKCS. The Strategy should not be suggesting, for example, that the holder of valuable petroleum rights might somehow be forced to transfer them at less than fair value – this should never be necessary. However, it does make sense for the Strategy to record that where a relevant party is benefitting (or may benefit) from a market failure (e.g., because it owns or operates inadequately regulated "natural monopoly" infrastructure) it will not be permitted to reap excessive returns or other benefits. The Strategy should also clarify that interests of relevant parties that have made historical "sunk" investments that would, if production in the UKCS collapses, be holding stranded assets must, given current threats to the UKCS, be subordinated to the interests of existing producers as well as investors in new upstream exploration and development and critical infrastructure.

d. <u>High level principle "d"</u>: This principle states that "compliance with the Strategy should not lead to any individual company investing in a project or operating existing assets where there is not a satisfactory expected commercial return on that investment" and that in this context "a satisfactory return does not necessarily mean a return commensurate with the overall corporate return on their portfolio of investment, e.g. a low risk investment could give low returns". This touches on the same issue we have discussed above in relation to the Safeguard in paragraph 2. We note the difference in wording, and wonder whether this is intentional. (As a drafting matter, the Strategy should not be dealing with the same subject matter in two different places and in different ways as this will merely lead to confusion and disputes.)

<u>QUESTION NO. 3 - Do the Obligations, as drafted, provide sufficient clarity on the required actions or behaviours? If not, which aspects need to be clarified?</u>

<u>Overview</u>

The Obligations, as drafted, <u>do not provide sufficient clarity on the required actions and behaviours</u>. We are particularly concerned about the lack of clarity in relation to the actions and behaviours of owners and operators of critical UKCS infrastructure. We have set out below some specific examples where further clarity is needed relation to (a) access to the UKCS infrastructure, (b) the decommissioning of UKCS infrastructure, and (c) the development of new UKCS infrastructure.

Access to UKCS Infrastructure

Our suggestions for the Strategy in relation to third-party access to infrastructure are outlined below:

1. Binding TPA framework: The Strategy should contain all the key elements of a new, fit-for-purpose third party access framework based on best practices globally, which would replace current DECC Guidance and the industry-led ICoP (which, as well as being inadequate for the UKCS's current requirements, is not legally binding).

2. Cost reflective access tariffs: The Strategy should provide that access tariffs must always be cost reflective, containing charges only for (i) allocated and reasonable service (i.e., operating) costs, (ii) allocated and permitted capital costs and (iii) connection costs (each of these is discussed further below).

3. OGA oversight of service cost charges: The Strategy should provide that all charges for service costs should be "reasonable" and will be subject to review, approval and/or adjustment by the OGA based on detailed published guidelines and criteria.

4. Reform of cost sharing options: "Free options" for infrastructure owners to convert at a time of their choosing to a cost sharing arrangement are a common feature in UKCS infrastructure access arrangements (and were historically encouraged by DECC policy). These are, in our view, inconsistent with the concept of cost reflective tariffs set out in paragraph 2 above, and their status needs to be carefully considered by DECC and the OGA. Where infrastructure owners have not yet exercised their cost sharing option, it is reasonable to assume that they are charging tariffs that exceed a cost reflective tariff, which should never be permitted. The terms of typical cost sharing arrangements are, we believe, often unfair as regards the allocation of operating and capital costs to users (see again the Howe/Nelson dispute for an illustration of some of the issues that arise). Moreover, the existence of free options (the exercise of which cannot be predicted with any certainty) complicates operational decisions, budgeting and long-term planning by existing users, and damages the prospects for new upstream investment. Based on the foregoing, we have formed the view that the current DECC-endorsed free option approach must be abandoned (and unwound) in favour of the cost reflective approach we have recommended, which should apply immediately and for the life of all infrastructure assets. This reform is a necessary and essential condition to achieving the Principal Objective.

5. Service costs (marginal barrels): The Strategy should provide that only marginal (i.e., not average) service costs may be allocated to barrels whose economics are "marginal" (as determined from time to time by the OGA based on detailed published guidelines and criteria).

6. OGA oversight of capital cost charges: The Strategy should provide that all capital cost charges are subject to review, approval and/or adjustment by the OGA based on detailed published guidelines and criteria, including with respect to (i) cumulative amount invested, (ii) reasonableness/prudency of investments, (iii) depreciation charges/rates, (iv) capital structure assumptions, cost of debt, permitted rate of return on equity and resulting weighted average cost of capital and (iv) adjustments (e.g., for stranded assets).

7. Capital costs (marginal barrels): The Strategy should provide that no capital costs associated with any existing "sunk" UKCS infrastructure investment (regardless of the circumstances under which it was developed) should be allocated to barrels whose economics are "marginal" (as determined by the OGA). We note that as long ago as 1975, UK government assurances given in the House of Lords (which DECC purports to follow to this day) confirmed that persons seeking access to UKCS infrastructure would need to pay a share of its basic capital costs "unless the supply in question is a marginal one or the pipeline owner has already made other sufficient arrangements to recover the full capital costs" (emphasis added). It is concerning that DECC has never sought to define what is meant by "marginal supply" in this context, nor made any attempt in its guidance to apply a different approach to allocating capital costs to high-cost

barrels. The Strategy represents an excellent opportunity to correct this omission, at a time when the number of "marginal supplies" in the UKCS is proliferating as commodity prices continue to fall.

8. Capital costs (integrated vs. "merchant" infrastructure): DECC guidance has for many years attempted to distinguish between (a) infrastructure that forms part of an integrated operation and for which the initial investment decision was based on transporting the owner's own barrels, on the one hand, and (b) infrastructure constructed on a speculative or "merchant" basis, on the other. Owners of infrastructure described in (a) are not permitted to allocate capital costs to third party users, whereas owners of infrastructure in (b) are. This system has operated without close scrutiny for many years, and determinations as to:

   - which category infrastructure falls into (often DECC's distinctions cannot be easily applied);
   - the original capital cost;
   - the costs of capital improvements;
   - requires rates of return; and
   - whether or when merchant infrastructure has finally delivered an appropriate return,

   have been left to infrastructure owners. This is clearly an unacceptable situation, which should be addressed by the Strategy. Infrastructure owners should not be entitled to be their "own judge and jury" in these matters, nor should they be able to earn returns on their capital investments indefinitely.

9. New UKCS infrastructure: The Strategy should authorise the OGA to pre-agree investment assumptions and parameters (i.e., underlying future tariffs) for a major greenfield investment in UKCS infrastructure covering a fixed period (which could, for example, be based on the term of third party debt financing) where the OGA determines that greater certainty is necessary to attract the required investment, or is otherwise appropriate in order to reduce the cost of capital and access tariffs in the interests of MER-UK.

10. Connection charges: The Strategy should provide that any owner of existing infrastructure that requires modification to accommodate new users should fund such costs directly and recover such costs in the form of periodic "connection charges" - provided that certain conditions are met[14]. Such conditions should relate to (i) the creditworthiness of the user (or its guarantor), (ii) execution of a bankable "ship-or-pay" contract, (iii) the cash flows under such contract providing a reasonable return on the owner's investment and (iv) such modification not qualifying as a "major expansion project" (as defined by the OGA). Currently, UKCS infrastructure owners are in such a strong position that they routinely require users themselves to fund such modifications "up-front". This puts undue pressure on users, particularly as the improvement is not being made to their asset and, accordingly, cannot generally be funded using third party financing. The infrastructure owner is in a much better position to arrange such funding, either from its own funds or third party financing secured by the modification assets and/or its "bankable" contract with the user. In other jurisdictions, infrastructure owners are for this reason commonly required to undertake and fund such modifications, and are fairly compensated for doing so. We recognise that in the UKCS, where infrastructure is largely owned and controlled by major oil companies, this recommendation may be highly unpopular. However, our approach would, we believe, be quite acceptable to most dedicated infrastructure operators and similar independent investors and might, in combination with other reforms, help to encourage "unbundling" in the manner envisaged by the Wood Review.

11. Own-use capacity reservations: The Strategy should reform current DECC Guidance in relation to infrastructure owners seeking to reserve infrastructure capacity for their own "reasonably anticipated"

[14] Owners can currently elect to require the third party user to fund such costs.

future production[15]. The current guidance has always been open to abuse by owners and should, in our view, now make way for a "first come, first served" approach that is aligned with goal of MER-UK and recognises the current reality facing the UKCS. Such a reform could also have the collateral benefit of encouraging any owner infrastructure that has reserved capacity for future development of a petroleum reserve to accelerate its investment plans – i.e., to "use it or lose it'.

12. Enhanced transparency: The Strategy should significantly enhance transparency consistent with global best practices, in order (a) to encourage greater investment in UKCS exploration and development, (b) to facilitate negotiated TPA deals and (c) to encourage and enable monitoring of compliance with the TPA regime; consideration should be given, among other things, to requiring publication of OGA-approved access tariffs or, where appropriate, "reference tariffs". It is essential that the Strategy specify the types of information that must be disclosed, and the precise mechanics and timing of such disclosure. For the most part, such information should be made freely available in the public domain, in order to facilitate investment in early-stage exploration. By including this detail in the Strategy, which is legally binding, private sector participants in the UKCS will benefit from a "safe harbour" under applicable competition laws, which might otherwise subvert the goal of transparency and the achievement of MER-UK.

Decommissioning of UKCS Infrastructure

Our suggestions for the Strategy in relation to decommissioning of UKCS infrastructure are outlined below:

1. Public Tender Prior to Decommissioning: Prior to any decommissioning of UKCS infrastructure it is essential that the OGA be able to determine whether or not the asset has any residual economic life/value. Due to extensive conflicts of interest and the potential for abuse of dominant positions by infrastructure owners, it is unsafe for DECC and the OGA to assume simply that because an owner is proposing decommissioning such residual value must be nil or negative. Accordingly, the Strategy should require that prior to making a proposal to decommission infrastructure the owner must have held a public tender process in accordance with rules and procedures established by the OGA from time to time. Any transfer of infrastructure from the owner to a third party in connection with a tender process should comply with specific requirements (see paragraph 2 below).

2. Transfer Terms: Given the strong position held by owners and operators of critical infrastructure, they are often able to extract value and unfair terms from users that are reliant on such infrastructure. This often goes beyond merely the issue of access tariffs, particularly when the owner no longer requires the infrastructure for its own production. In such cases, the owner can use a variety of tactics (including threatening decommissioning) to extract value from users who must either accept the terms being offered or be forced to shut-in their production. In this way an infrastructure owner can, for example: (a) force a user to purchase the infrastructure at a price exceeding its fair value (based on future expected tariff receipts determined on a cost reflective basis) and/or (b) force a user to assume significant liabilities associated with decommissioning the infrastructure (which would otherwise be borne by the owner/operator). DECC and the OGA must be live to these types of abuses, and act to prevent them. Specifically, the Strategy should provide that any and all transfers of infrastructure should comply with requirements established from time to time by the OGA. Such requirements should, in the case of decommissioning liabilities, carefully "fix" the outgoing owner's liabilities and ensure that the new owner's exposure is strictly limited to liabilities fairly allocable to the period of its ownership (based on the number and/or profitability of barrels produced or other appropriate measure).

   To be clear, we are not suggesting an alteration to the basic statutory scheme for decommissioning liabilities. Rather, we are asking DECC and the OGA to recognise that such liabilities are routinely allocated by private sector parties by contract and that, particularly in the case of late-life critical infrastructure, such allocation can undermine achievement of the Principal Objective.

[15] Current DECC Guidelines grant considerable latitude to owners and is significantly out of step with global best practice, which generally requires "open and non-discriminatory access", even where infrastructure is part of an integrated operation.

3. Early Warning of Financial Difficulties: Infrastructure owners and operators should be obliged by the Strategy to comply with rules (to be established by the OGA) that give "early warning" of pending financial difficulties, and include appropriate provisions in their financing documents requiring third party financiers to give prior notice to the OGA of planned enforcement proceedings. This should avoid situations, such as have recently occurred in the UKCS, where an integrated operator becomes insolvent and there is insufficient time to tender infrastructure for sale and no entity in existence can fund on-going operating costs during the process. Such situations can trigger the unnecessary decommissioning of infrastructure and are, in our view, entirely avoidable.

Development of New UKCS Infrastructure

Our suggestions for the Strategy in relation to encouraging and facilitating new UKCS infrastructure are outlined below:

1. Regulatory Certainty, Cost Reflective Tariffs: Our recommendations above in relation to clarity of regulation and cost-based access tariffs will maximise the prospects for new investment in UKCS infrastructure and upstream exploration and development.

2. Open Seasons: As noted in the Wood Review, as the UKCS matures it becomes increasingly important to ensure that infrastructure is developed on a regional basis so that it can support multiple (and often marginal) upstream developments. Competing natural resource companies are notoriously poor at coordinating such projects, for competitive and other reasons. In order to facilitate the development of regional infrastructure and promote "unbundled" structures, the Strategy should require all proposed infrastructure projects to following a public, transparent and fair "open season" process that follows rules established by the OGA. Such rules should be similar to those that are customary in the United States and Canada. The Strategy should also make clear that (a) proposals for infrastructure projects may be brought forward by independent third parties and (b) in the case of competing proposals the OGA will determine which will proceed to the open season stage based on its published criteria.

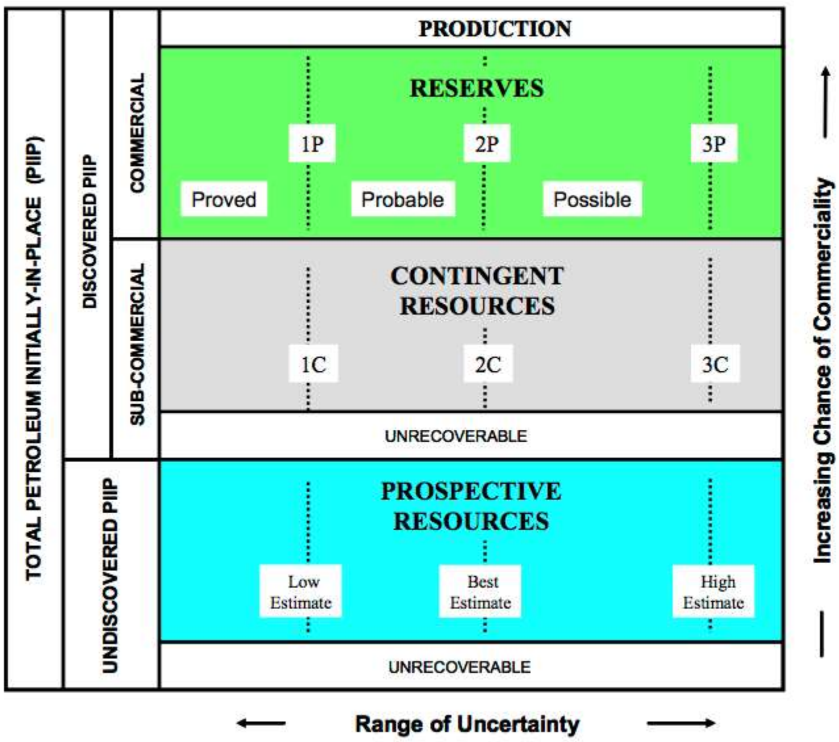
QUESTION NO. 4 - Do you think the term "satisfactory expected commercial return" is adequately defined for the purpose of guiding all parties bound by the Strategy? If not, why not?

In our view, the term "satisfactory expected commercial return" is not adequately defined. Please see our comments under Question 2, paragraph (ii) above.

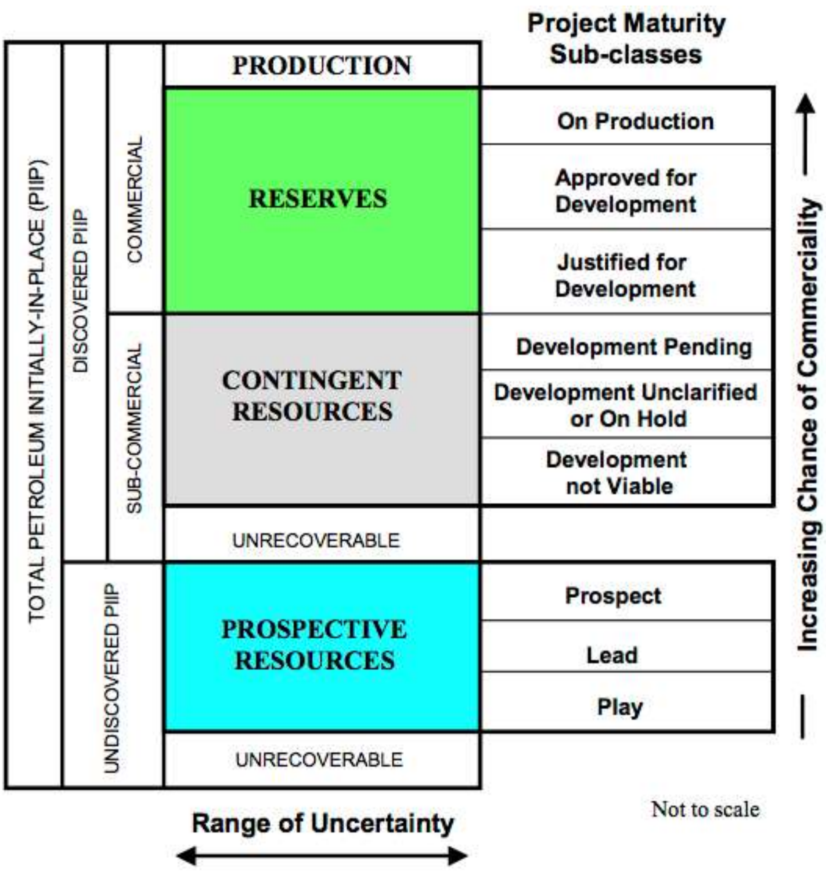
QUESTION NO. 5 - Do you think the term "economically recoverable" is adequately defined for the purpose of guiding all parties bound by the Strategy? If not, why not?

The term "economically recoverable" as defined in the Strategy is unclear and untested, and will lead to uncertainty, disagreements and disputes. Our main definitional concerns are set out below:

1. Uncertainties associated with petroleum exploration and recovery: The term "economically recoverable" as simply defined in the Strategy is not aligned with internationally accepted terminology. Accordingly, it fails to incorporate a number of important concepts, including that "commerciality" (a) changes over time based on commodity prices, technological advances and other factors, (b) is subject to a range of uncertainties and (b) is typically seen as sitting on (or measured against) a relative scale. This is illustrated in the following table:



2. Project approval and development process: The term as defined in the Strategy also fails to reflect the normal process by which a project moves from being a prospective resource, through being a contingent resource and then to a reserve. This is reflected in the following table:



3. Subjective judgements: The term fails to reflect the fact that any determination of whether or not a particular petroleum accumulation can and/or should be produced involves a large number of subjective judgements, for which there is no "right" or "wrong". The Strategy provides no clarity on who is responsible for making these judgements, whether such judgements can be challenged, or the basis on which the reasonableness of such judgements will be assessed.

4. Single discount rate: The use of a single real discount rate does not accord with the way business decisions are taken in the UKCS or most other offshore basins globally. The discount rate to be applied should, in our view, be based on the risks associated with the particular decision or investment. For example, a decision to drill a further well in an active field for which infrastructure is already in place involves relatively low risk, and should apply a relatively low discount rate. Conversely, a decision to undertake initial development of new field and associated infrastructure involves significant financial, technical and other risks, and should apply a relatively high discount rate. By adopting a simplistic approach that is inconsistent with the way commercial decisions are taken, the definition risks undermining investor confidence in the UKCS.

   Particular care should be taken concerning mandated discount rates for UKCS infrastructure investments. As indicated in the Wood Review, infrastructure should not be treated as (or permitted to be) a high margin business in the UKCS. A 10% real rate of return would certainly be regarded as high margin in the context of infrastructure assets which, as noted above, often only require returns of <5%. One possible way for DECC and the OGA to encourage unbundling of integrated operations in the UKCS would be to limit permitted rates of return on capital invested in UKCS infrastructure in line with a "utility-type" business model.

5. Long term price assumption: We note that the term does not incorporate a single long-term oil price assumption (or basis for determining one), which seems anomalous given the use of a single discount rate. Most petroleum companies make investment decisions based on long term price assumptions, which are adjusted periodically. There is some precedent for regulatory authorities requiring the use of common oil price assumptions (e.g., the U.S. Securities and Exchange Commission does this to standardise disclosure of petroleum reserves). DECC and OGA may wish to consider this option.

We recommend that, instead of developing a new, simplified and untested definition to capture a highly complex concept, DECC and OGA should incorporate into the Strategy relevant terminology contained in the internationally-accepted Petroleum Resources Management System, which is sponsored by the Society of Petroleum Engineers International, the American Association of Petroleum Geologists, the World Petroleum Council and the Society of Petroleum Evaluation Engineers[16].

* * * * *

We appreciate the opportunity to provide these comments. Should you have any questions or require further information, please do not hesitate to contact the undersigned on glen.ireland@infra-share.org.

Yours sincerely,

Glen Ireland
Founding Partner

cc: Mark Aplin, InfraShare Partners

16 See: http://www.spe.org/industry/docs/Petroleum_Resources_Management_System_2007.pdf