



DEFUSING THE DECOMMISSIONING TIME BOMB

OIL AND GAS COMPANIES MUST COLLABORATE
TO CONTAIN THE POTENTIALLY CRIPPLING
COSTS OF REMOVING OFFSHORE FACILITIES

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Oil and gas companies have installed thousands of structures offshore in the earth's oceans, and the time is quickly approaching for those wells, pipelines and other pieces of equipment to begin coming out.

Already in some basins, such as the United Kingdom's continental shelf, low production, falling efficiency, aging assets and rising decommissioning liabilities are making production less attractive. Now, persistently low oil prices are putting pressure on producers to consider the costly and irreversible decision to decommission those structures.

Operators must dispose of the equipment properly to meet regulations and to avoid spills that could damage the environment. Decommissioning this equipment will cost hundreds of billions of dollars and represents new operational risks for most companies. The costs have started to impact company balance sheets through provisions, and depending on the jurisdiction, much of the burden will be borne by governments. (See Exhibit 1.)

POOLING EFFORTS

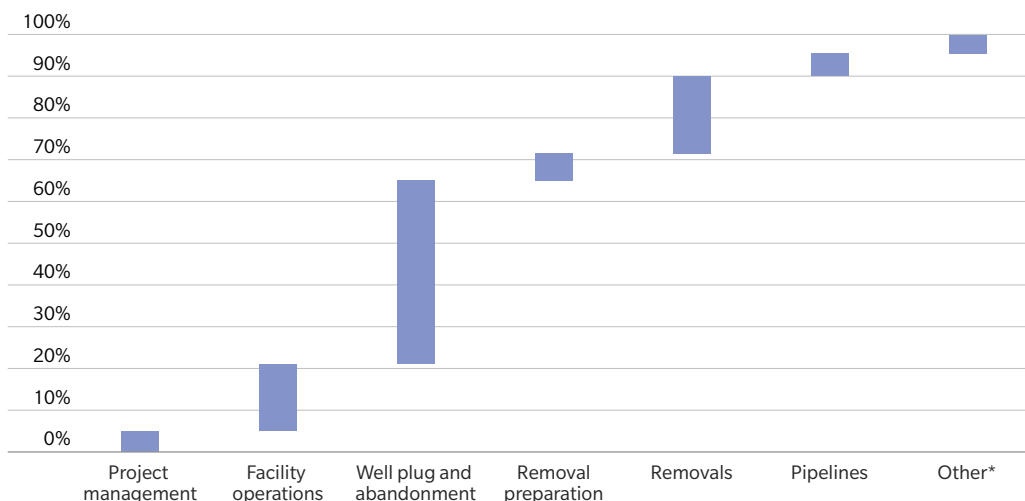
If each oil and gas company forms its own decommissioning operation, the total cost may balloon. Each company will have to undergo a learning curve of developing the capabilities and of gaining the necessary experience, and inconsistencies could impact the resulting work. Pooling the efforts would be more efficient and, according to an Oliver Wyman analysis, could reduce costs by more than 25 percent through the combined benefits of: increased purchasing power in the supply chain; improved learning and knowledge sharing; better information for central planning and coordination; reduction in duplicated decommissioning skills; and improved financial control and transparency.

Independent producers and companies with a small number of structures could benefit the most, establishing decommissioning syndicates that could harness and realize the benefits from pooling efforts. To a lesser degree, increased collaboration among international oil

EXHIBIT 1: DECONSTRUCTING DECOMMISSIONING

A breakdown of decommissioning costs

PROPORTION OF TOTAL EXPENDITURE FOR EACH ELEMENT OF DECOMMISSIONING



*Other includes site remediation, onshore recycling and monitoring

Source: Oil & Gas UK; Oliver Wyman analysis

companies, which focuses on sharing data and services and improving financial control, could cut the cost of decommissioning by up to 15 percent. Syndicated independents and larger oil companies alike could significantly improve their balance sheets by spinning off the unprofitable assets into a separate decommissioning company, similar to a bad bank.

The UK continental shelf, one of the most mature offshore oil and gas producing regions, will be an immediate test case. Most of the platforms are more than 30 years old, and only around 7 percent of the assets have been removed, according to the UK Department of Energy and Climate Change. But that amount will soon rise. The offshore industry association Oil & Gas UK believes that more than 2,300 kilometers of pipeline, infrastructure from 74 fields, over 70 subsea projects and more than 130 installations are scheduled for decommissioning in the North Sea during the next decade.

BALLOONING COSTS

The equipment removal that has already taken place in the basin was carried out sporadically, with little communication among operators. This strategy has resulted in projects being delivered, on average, 40 percent over budget, according to the UK's Department of Energy and Climate Change. Operators assign their limited resources to an activity that creates no value. They have little leverage on supply chain costs, and with the limited number and long lead time of projects, it's difficult for individual companies to retain knowledge and talent for future work. There's also a risk of stranded and untapped reserves due to early or poorly synchronized decommissioning across the region.

Average annual spending on decommissioning in the region is forecast by Oil & Gas UK to rise to more than \$3 billion by 2018, from \$2.25 billion in 2014. Relief from UK's petroleum revenue tax is meant to pay for

the majority of decommissioning, but the decommissioning cost will rise significantly just as production declines. If tax receipts continue to plunge as they have in recent years (receipts were just \$7 billion in 2013-2014 compared with \$17 billion in 2011-2012), the government will need to look outside of oil and gas production to pay for decommissioning.

SEPARATING NONPERFORMING ASSETS

As part of the collaboration, operators should consider forming a separate company that owns the physical end-of-life assets and performs the removals. We estimate the potential members of such a syndicate in the UK continental shelf, independent producers and those with few assets, could save as much as \$7.5 billion. This strategy is similar to what happened in the financial world with the creation of so-called "bad banks," a strategy that, according to news reports, ultimately resulted in major benefits.

Separating nonperforming assets into a new company focuses investors and counterparties on the bank's healthy, core activities. This boosts investor confidence through a clear investment thesis, improving the bank's share price and ability to raise capital. The goal is not to make the bad bank into a profitable company, but to manage risk and avoid asset fire sales. Most importantly, the bad banks create strategic options. They can work with many different buyers or consolidation partners, and make use of alternative forms of capital or risk transfer.

An oil and gas decommissioning company could see similar benefits. The assets would shift to a separate company that is run and partly funded by operators, with financing from institutional investors seeking yield from long-term debt. The new decommissioning company can explore the best approach to unwind its holdings, develop true world-class decommissioning capabilities,

create economies of scale from resources, equipment and technology, and influence the supply chain, regulators and governments.

A NEW MODEL

This radical, industry-shaping change won't be easy. A key group of operators must commit to collaborate. Roadblocks may exist for funding, governance, data sharing and tax liabilities. Operators must agree on allocation methodologies, roles and processes, and secure systems for data, among other issues. Governments must amend laws and tax structures.

The issues facing the fledgling decommissioning industry are certainly challenging, particularly as work shifts from the relatively easier shallow waters to deep-water facilities. But if the UK continental shelf operators can collaborate on decommissioning these initial shallow-basin structures, they will then be able to lay the groundwork for the technical and financial models that will be needed to tackle the more complex deep-water structures. The time to begin the grand collaborative effort is now.

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