BRACEWELL

INSIGHTS

Predictable unpredictability: stranded assets and the scope for disputes under PSCs

August 13, 2020

By: ***John Gilbert*** *and* ***Robert Meade***

Summary

In the current climate, many exploration and production companies are looking to reduce capital expenditure and to streamline their operations. They are also reassessing their demand and price forecasts and considering the impact on their balance sheets. In this article we consider how the desire of contractor parties to reduce costs on the one hand, and the wish of producing states to maximise returns on the other, has the potential to increase disputes under production sharing contracts, in particular in connection with the minimum work and expenditure obligations.

An unpredictable start to the new decade

Stranded assets are defined by the International Energy Agency as those investments which have already been made but which, at some time prior to the end of their economic life, are no longer able to earn an economic return.[1]

At the beginning of February 2020, the Financial Times predicted that the oil and gas industry could face around $900 billion of its value evaporating as a result of so called stranded assets.[2] This estimate was based on the assumption that governments around the world would aggressively attempt to restrict the rise in temperatures to 1.5C above pre-industrial levels for the rest of this century, meaning that over 80% of the world's remaining fossil fuels would have to stay in the ground.

Later that month, the SARS-CoV-2 virus went global. On 11 March 2020, the WHO declared a pandemic. National lockdowns followed, and international travel all but ceased. The effect on the world's energy demand was swift. The IEA stated that, in mid-April 2020 "*countries in full lockdown are experiencing an average 25% decline in energy demand per week and countries in partial lockdown an average 18% decline*".[3]

This unprecedented global health crisis coincided with a collapse in oil prices following OPEC's decision to lift supply restrictions. A perfect storm ensued. Brent Crude fell from just under $60/bbl on 21 February 2020 to under $21/bbl on 21 April 2020.

The status quo had shifted and the industry had to react. At the end of April 2020, Shell cut its dividend. This was the first time it had done so since the Second World War. In mid-June, BP announced that it was revising its long-term oil price forecast down to $55/bbl. A similar revision was made to its price assumptions for natural gas. This resulted in the value of its assets falling by an estimated amount of $17.5 billion. Shell made a similar move at the end of June 2020. As a result of the change in its price assumptions, the value of Shell's current portfolio of oil and gas assets fell by an estimated $22 billion.

The Financial Times published a further article at the beginning of July, stating "*Executives who for years rejected the prospect of 'stranded assets' are acknowledging publicly the risk that swaths of their oil, gas and refining assets will be rendered uneconomic, with vast hydrocarbon reserves never being extracted and burnt*".[4]

It remains to be seen how this story will play out. The end has not yet been reached, with BP also cutting its dividend at the beginning of August 2020. No-one has a crystal ball, and the first seven months of this decade have shown that all we can reliably predict is that the unpredictable will occur. Only time will tell whether assets have truly become stranded. However, whether because of supply glut, fall in demand, pandemics, the energy transition or a combination of all of these factors, oil and gas assets are likely to look less appealing to investors than they did before the start of the year. This will create tension. In particular, between the International Oil Companies ("**IOCs**") that acquired the exploration and development rights over the assets and the producing states and NOCs they contracted with. Tension in any commercial relationship heightens the prospect of disputes arising.

Tension under PSCs

Many of the IOCs will be looking to curb capital expenditure, in particular in respect of assets that are no longer as economically favourable. However, states that rely on the export of oil and gas to support their economies will most likely want to maximise investment and, ultimately, production so as to boost their revenues. This is particularly the case at the current time, when those states are having to invest vast sums in their public health infrastructure and the low oil prices have significantly impacted their economies. States that rely on hydrocarbons as the primary source of their revenue might also acknowledge that the energy transition may lead to lower revenues in the future and push to maximise their returns now. We are, therefore, likely to see private companies taking extraordinary measures to cut expenditure at the same time that their state counterparties wish to maximise investment.

One of the most popular forms of arrangement for the exploration and production of oil and gas is the production sharing contract, or PSC. This is an agreement between one or more IOCs as contractor (which we will refer to in this article as the contractor parties) and the relevant state. Almost all of the PSCs used around the world require the contractor parties to commit to carrying out a minimum amount of work (such as a gathering a specified amount of seismic data and drilling a certain number of wells) as well as incurring a minimum amount of expenditure, all within set time frames. The financial commitments made by the contracting parties will usually amount to tens-of-millions of dollars, and may be in addition to any signature bonus paid to secure the PSC in the first place.

States will often seek some form of security in respect of these minimum work and minimum expenditure obligations. This might take the form of a parent company guarantee, on demand letter of credit or an express obligation to pay a liquidated sum to the state which corresponds to the financial commitment made. The contractor parties may seek to resist granting such security, but ultimately this is a point to be agreed during the PSC negotiations and in some jurisdictions is a non-negotiable price of entry. A failure to undertake and complete the minimum work and expenditure obligations may also entitle the state to terminate the PSC. Failure to comply with the minimum work and expenditure obligations can, therefore, have severe ramifications.

A fertile area for disputes

It seems almost inevitable that we will see more IOCs attempting to minimise further expense on assets which are no longer seen as economically viable or to defer their minimum work and expenditure obligations in respect of those assets. For the most part this is likely to be done by agreement. However, reaching such an agreement will not always be possible. Where it is not, IOCs may look for other ways to achieve their goal.

Depending on the terms of the PSC in question and the applicable governing law, several options may be available to them. For example:-

11. 1. PSCs will often deem the contractor parties to have met the minimum expenditure obligations in circumstances where the minimum work obligations have been completed. Where this is the case, the contractor parties should not face liability, or a call on any security given, so long as the required work has been carried out (even if performed at a lower cost). Contractor parties might, therefore, look for ways to satisfy the minimum work obligations such that the deeming provisions come into play. Any dispute over whether that is the case is likely to turn on both factual an expert witness evidence.

12. 2. Potentially linked to the previous point, some PSCs will provide that the contractor parties will be deemed to have met the minimum work obligations in certain circumstances. For example, it is not uncommon to see a provision stating that an exploration well will be deemed to have been drilled to the required depth, and the minimum work obligations in respect of that well therefore satisfied, where continued drilling would present a hazard or danger. Sometimes the assessment of whether this is the case is to be made by the contractor parties themselves. As a result, contractor parties may take a more risk averse approach to the assessment of hazards than they might have done in the past, allowing them to avoid drilling exploration wells to target depth (noting, of course, that the goal of the contractor parties is to discover hydrocarbons – so the target depth may be a commercial necessity in order to reach the anticipated reservoir). Whenever a contract permits one party to make a decision such at this, questions naturally arise as to whether it has done so properly.

13. 3. The expenditure that can be counted towards the satisfaction of the minimum expenditure obligations might be open to interpretation. The contractor parties might be able to argue for a broad interpretation, permitting an argument that the

obligations have been satisfied or that a greater proportion of the minimum expenditure obligation has been met, meaning a lower payment to the state. Conversely, the state might be able to argue for a narrow interpretation, which could lead to a call being made on any security granted.

14. 4. The PSCs might provide for extensions to the periods for performing the minimum work and expenditure obligations in certain circumstances. Such provisions might permit the contractor parties to defer those obligations until a later date, but whether the necessary circumstances exist might be disputed. Absent wording to this effect, any extension could only be obtained with the state's agreement.

15. 5. One or more of the contractor parties might look to divest a portion of their interest in the asset, with a view to reducing their exposure by decreasing their share of costs. This would require the state's consent and, sometimes the payment of a fee. Depending on the nature of the incoming transferee, such a transfer may also give rise to disputes.

A number of options could, therefore, be available to contractor parties. Depending on the factual circumstances, there may be significant scope for dispute surrounding their application and whether, or to what extent, the minimum work and/or minimum expenditure obligations have been satisfied.

How an IOC chooses to proceed will necessarily turn on the provisions of the PSC in question, the applicable governing law, its appetite for risk, and whether it foresees an ongoing relationship or the potential for new opportunities with the state in question. In addition, the views of the other contractor parties will likely play a role. One contractor party might want to reduce expenditure and/or defer its obligations. The other, however, might have an urgent economic need for a discovery, and wish to push forward with exploration. This is a further example of tension, this time tension that may give rise to disputes between the contractor parties under joint operating agreements entered into the pursuant to the terms of the relevant PSC.

States may also be looking closely at the provisions of their PSCs to identify any angles that could permit them to make a return in a shorter timescale. As foreshadowed above, this might involve considering when any security that has been granted may be called. A state naturally needs to balance this desire for short term gains or investment expenditure by contractor parties against the risk of being seen as unfriendly to investors and thereby reducing future potential investment or interest in licensing rounds.

Concluding remarks

The debate regarding stranded assets will continue. Whether an asset will be able to earn an economic return in the future is dependent on many factors that are continuously in flux. It is a question that must, therefore, be continually reassessed, and who knows what the future holds. However, the current environment is likely to lead to attempts by IOCs to curb expenditure on the exploration of oil and gas assets. This will lead to tension between the IOCs and their state counterparties. It might also lead to tension between groups of IOCs that have agreed to explore the affected assets.

That tension is likely to lead to an increase in disputes. It seems that the unpredictable will always occur and, perhaps predictably, disputes will result.

---

[1] IEA, *Redrawing the Energy-Climate Map: Work Energy Outlook Special Report*, 2013

[2] ***Lex in depth: the $900bn cost of 'stranded energy assets'***, 4 February 2020, Financial Times

[3] ***IEA Global Energy Review 2020***, April 2020

[4] ***Oil majors face up to plunging asset values***, 2 July 2020, Financial Times