Oil & Gas Authority

Consultation

on the approach to “satisfactory expected commercial return” in the MER UK Strategy

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The consultation can be found on the OGAs website:

https://www.ogauthority.co.uk/news-publications/consultations/

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Contents

1. General information

Purpose of this consultation

To set out, and seek industry views on, the OGA's proposed approach for assessing whether there is a "satisfactory expected commercial return" (SECR), as defined in the Maximising Economic Recovery (MER) UK Strategy, on an investment or activity.

- The OGA is intending to assess SECR only for the purposes of and as set out in the Strategy.
- The OGA has no intention of expanding the application of SECR or to use the resulting test for other purposes.
- The OGA is seeking to clarify SECR as an objective and pragmatic test, with a targeted number of metrics. The OGA is aware companies use a wide range of metrics and inputs in assessing returns, not all of which are included in the proposed SECR test. The OGA fully expects companies to continue to use their own hurdles for their purposes.
- In any case where the SECR test is applied, the OGA will take a pragmatic approach including full detailed discussions between the OGA and companies to establish the best understanding of the project. Data considered would include the geological, engineering, project timing, cost expectations, production profiles, prices, exchange rates and the risks associated with these.
- The MER UK Strategy cannot be used to compel a company to invest in any project. Where a company does not wish to invest in a project that would nevertheless achieve MER UK, the Strategy follows a general approach of 'use it or lose it'.

Issued: 13 December 2017

Respond by: 01/03/2018

Territorial extent: United Kingdom and UK Continental Shelf

Responding to this consultation

The OGA invites written views and comments on the proposed guidance, to be made by 01/03/2018. Your response will be most useful if it is framed in direct response to the questions posed, though further comments and evidence are also welcome.

Please submit your response by email or post (email preferred).

The OGA has produced a coversheet for responses (see Annex 3) and asks that you complete and include it with your response, which should speed up the processing of responses, and help to maintain confidentiality where appropriate.

Written responses to the consultation should be sent to:

SECR consultation
The Oil and Gas Authority
21 Bloomsbury Street
London
WC1B 3HF

Email: SECR@ogauthority.co.uk

Representative groups are asked to give a summary of the persons or organisations they represent when they respond.

Additional copies:

Other versions of the document in Braille, large print, audio or Welsh can be made available on request. Please contact us using the ‘enquiries’ details to request alternative versions.

Confidentiality and data protection

If you think any part of your response should be kept confidential, please place such part(s) in a separate annex to your response and include your reasons why this part of your response should not be published. For example, this may include information such as your personal background and experience. Therefore, if you want your personal details to remain confidential, please provide them in your coversheet only so that the OGA does not have to edit your response.

If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this.

Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to the OGA to use for its regulatory remit.

Quality assurance

This consultation has been carried out in accordance with the government’s consultation principles.

If you have any complaints about the consultation process (as opposed to comments about the issues which are the subject of the consultation) please address them to:

Matthew Garland
21 Bloomsbury Street
London
WC1B 3HF

Email: matthew.garland@ogauthority.co.uk

2. Introduction

(i) The Maximising Economic Recovery Strategy for the UK (the Strategy) places an obligation on companies and the OGA to take the steps necessary to secure the maximum value of economically recoverable petroleum from the United Kingdom's continental shelf, this is termed MER UK. To ensure that this obligation does not damage confidence or discourage investment and in order that it is applied predictably, a number of safeguards are provided together with a framework for the approach that the OGA and licensees should take in their discussions when together they seek to secure MER UK.

(ii) An important safeguard, introduced at the request of industry and the subject of this consultation, is satisfactory expected commercial return, SECR. In summary, this safeguard makes it clear that companies are not obliged to invest in projects which, though they meet MER UK, would not pass the objective SECR test.

(iii) In circumstances where a company does not wish to invest in a project that would nevertheless achieve MER UK, the Strategy follows an approach of 'use it or lose it' and the company is obliged to seek alternative funding or to divest themselves of the asset. If, after a reasonable period, the company has been unsuccessful in these marketing efforts but the project passes the SECR test then the company is obliged to relinquish the licences related to the project.

(iv) The SECR safeguard therefore has two main aspects: it provides a company with protection from OGA enforcement powers with respect to projects which fail an objective SECR test; and also protects them as part of the Strategy's use it or lose it process as referenced above.

(v) The SECR test should be viewed by investors as a reasonable and predictable safeguard to be applied by the OGA rather than as a mechanism to force activity on fundamentally uncommercial projects, which is neither the intention of the OGA nor would this be allowed under the Strategy.

(vi) The SECR test was introduced, for the use of the OGA, as a safeguard for investors and is not intended, nor will it be used, as a mechanism to set limits on levels of return on investment. Neither is it intended to introduce an industry standard for commerciality – as companies will continue to use their own measures of satisfactory return to make decisions on whether or not to invest in projects. The separate safeguard in paragraph 4 of the Strategy also provides, independently of the objective SECR test, that where a company chooses to delay or not undertake investment or funding because the company itself considers the return insufficient the OGA must discuss with the company before taking any enforcement action in relation to that decision.

(vii) In any consideration, there will be full detailed discussions between the OGA and companies to establish the best understanding of the project. Data considered would include the geological, engineering, project timing, cost expectations, production profiles, prices, exchange rates and the risks associated with these. In practice, these parameters, risks and projections would normally be generated by the company with the OGA assessing these in terms of such things as objectivity and reasonableness.

(viii) This consultation is primarily concerned with the test to be used by the OGA in assessing SECR for the purposes of the Strategy. The OGA is aware that industry uses a wide range of parameters, not all of which are covered in this document. The OGA further notes that a number of measures are commonly used by companies in the UKCS when considering return including payback period, Internal Rate of Return (IRR) and Profitability Index (PI). Many of these measures are underpinned by calculations of Net Present Value (NPV) or Expected Monetary Value (EMV) with the discount rates used in that calculation being significant elements of the analysis.

(ix) Also, PI is used extensively by industry based on NPV calculations using, for the most part, a Weighted Average Cost of Capital (WACC) for discounting. As discussed further, the OGA sees many advantages to this approach, not least because it provides a mechanism to incorporate capital rationing and to distinguish, by means of differing WACC values, projects types of different systematic risks.

(x) This consultation seeks views on whether NPV/EMV and PI (using a WACC discount rate appropriate to the type of project) is an appropriate measure for the OGA to assess SECR for the purpose of the Strategy. In responding, companies are invited to set out their view of whether this is a sufficiently practical and objective measure and, if not, evidence of an alternative measure(s) and how this could form an objective test.

(xi) Due to the commercial sensitivity of company PI thresholds and WACCs there is limited evidence on the current values that an efficient company might reasonably apply to these calculations. The consultation sets out a framework that differentiates between appropriate WACCs for exploration & production and for infrastructure type projects, and puts forward a range of potential values for these and for a PI threshold. The consultation seeks views on the appropriateness of these values and welcomes evidence in respect of which values would be appropriate, including values that companies are currently using.

3. Background and purpose of consultation

1. The Wood Review [1] (the Review) was commissioned to establish how to secure maximum value from the UK Continental Shelf (UKCS), recognising the changing nature of the basin as it matures. The Review made four key recommendations to maximise economic recovery from the UKCS, one being to develop and commit to a Strategy for maximising the economic recovery from the UKCS.

2. Following a consultation process and a response by the UK government[2] the implementation of the Wood Review recommendations led, among other things, to the setting up of the Oil and Gas Authority (OGA)[3] , establishing the principal objective for the OGA and industry to maximise the economic recovery of UK petroleum (MER UK)[4], and the production of a strategy for enabling that principal objective to be met (the Strategy).[5]

3. In November 2015, prior to the OGA vesting as a Government Company, the Department of Energy and Climate Change (DECC), now the Department for Business, Energy and Industrial Strategy (BEIS) consulted on the (draft) Strategy - to seek views on its suitability, in particular from those subject to the Strategy.[6]

4. It was confirmed in the Government response to that consultation, that *"Government believes that to enforce this obligation,* ***the OGA needs to be able to rely upon an objective test of whether a particular investment or activity is capable of achieving a satisfactory expected commercial return****, and does not agree that the test should be determined solely by each individual relevant person. However, the definition of what is a satisfactory expected commercial return has been amended to give greater clarity over the factors that might be applicable to a particular investment or activity. The revised definition is: "satisfactory expected commercial return" means an expected post-tax return that is reasonable having regard to all the circumstances including the risk and nature of the investment (or other funding as the case may be) and the particular circumstances affecting the relevant person".*[7] [OGA bolds]

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[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/471452/UKCS_Maximising_Recovery_Review_FINAL_72pp_locked.pdf
[2] https://www.ogauthority.co.uk/media/1018/wood_review_government_response.pdf.
[3] The OGA was initially set up as an executive agency of the (then) Department of Energy and Climate Change and then, with effect from 1 October 2016, as a Government company
[4] Specifically, section 9A of the Petroleum Act 1998 (as amended), sets out the principal objective of maximising the economic recovery of UK Petroleum, in particular through… development, construction, deployment and use of equipment used in the petroleum industry … and… collaboration among [relevant] persons with an obligation (section 9C) on all such relevant persons to act in accordance with the Strategy.
[5] The MER UK Strategy can be found at: https://www.ogauthority.co.uk/media/1022/mer_uk_strategy.pdf. See also the MER UK Strategy impact assessment - https://www.ogauthority.co.uk/media/1043/20160308_-_mer_uk__strategy_-_impact_assessment_-_signed_by_minister.pdf.
[6] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/477776/MER_UK_Consultation_document.pdf
[7] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/498128/MER_UK_Strategy_government_response_FINALdocx.pdf paragraph 57

5. In this consultation, the OGA presents (draft) guidance (Annex 1) which seeks to provide a clear analytical framework and a test to establish how the OGA will consider whether a specific investment or activity (herein referred to collectively as a “project”) achieves a SECR for the purposes of the Strategy, based on an objective assessment of whether the expected return would be considered satisfactory by an efficient relevant person (i.e. company). The OGA intends to minimise the complexity of the test for it to be useable in practice.

6. The OGA recognises there is a range of methods and approaches across industry and is not trying to impose a new standard for commerciality on the industry, the SECR assessment will be used by the OGA only for the purposes as set out in the Strategy.

7. To inform the preparation of this consultation document and (draft) guidance, the OGA commissioned Oxera Consulting LLP to provide advice on how economic principles may be applied to assessing whether projects achieve a SECR for the purposes of the Strategy. The findings have been used as an input in preparation of this consultation document and (draft) guidance.

8. The OGA does not intend, through this consultation process, to provide any further detail on the OGA’s sanctions process , nor is the (draft) guidance intended to provide wider guidance as to the circumstances under which the OGA will use its powers.

9. This consultation document and the attached (draft) guidance set out how the OGA proposes it will normally consider such matters, noting that the (draft) guidance is not a substitute for any regulation or law and is not legal advice. It is intended that the guidance will be kept under review and be revised as appropriate in the light of experience and developing law and practice and any change to the OGA’s powers and responsibilities. If the OGA changes its guidance in a material way, it will publish a revised document.

[8] The sanctions process and guidance can be found here: https://www.ogauthority.co.uk/regulatory-framework/powers-sanctions-guidance/sanctions/

4. What is SECR?

10. The Annex to the Strategy defines **satisfactory expected commercial return** as:

    an expected post-tax return that is reasonable having regard to all the circumstances including the risk and nature of the investment (or other funding as the case may be) and the particular circumstances affecting the relevant person.

11. In consideration of the above definition, and the references to SECR in the Strategy (see Annex 2), SECR therefore provides a test that is used by the OGA that safeguards a relevant person against having to make an investment or carry out an activity that will not produce an expected post-tax return that is reasonable. In making that assessment the OGA will discuss with the relevant person the relevant data and circumstances of the project. If it appears to the OGA that a reasonable return will not be made on the project, the relevant person will not be subject to a range of obligations and OGA enforcement powers.

12. The SECR test exists independently of a company’s own satisfaction with the expected returns or more general views of the attractiveness of the project to itself. Indeed, paragraph (d) of the introduction to the Strategy indicates that a SECR project may be one that does not meet a company’s portfolio rate of return. The OGA considers that the SECR test is based on whether an efficient company would consider the expected return from the project to be satisfactory.

13. Further, public companies listed on stock exchanges are required to report (“book”) their reserves, to benefit transparency to the investment community. Strict rules apply to this reporting. The OGA does not consider that the reserves “bookability” of a particular project is a substitute for either the MER UK threshold or for the SECR test, nor are all companies active in the UKCS listed. However, if it became apparent during analysis of a project that would otherwise have been considered to have passed the SECR test, that each efficient company contemplating that project would nevertheless be influenced by the bookability of the reserves, then the OGA would normally take this factor into its consideration.

14. Therefore, and in summary, SECR means – a reasonable expected post-tax return regarding a specific project. The OGA considers a reasonable expected post-tax return in this context is an objective consideration based on how an efficient company would act in relation to the specific project.

The circumstances to be taken into account

15. The definition of SECR in the Strategy sets out that regard has to be had to all the circumstances affecting that project. Examples of what circumstances are to be taken into consideration are given as:

    - the risk and nature of the investment (or other funding as the case may be); and
    - the particular circumstances affecting the relevant person.

16. However, these are not the only circumstances to be included in the analysis; it should be all the circumstances affecting the project, which could include that:

    - the project is one which is likely to be carried out only by a company with undiversified investors
    - there is significant value in delaying decisions associated with the project;
    - capital is constrained across the industry; and
    - there is significant downside risk to the project.

17. The circumstances to be considered are likely to depend on the facts of each situation. The SECR definition does not mean that equal weight should necessarily be given to all the circumstances being considered. Since, as set out above, SECR is an objective test, when having regard to the particular circumstances affecting a company the OGA would normally give little if any weight to circumstances that would not affect an efficient company contemplating the project.

Expected post-tax return

18. In this context expected means a calculated objective expectation of value rather than the subjective view of any one market participant, including the company currently considering the project.

19. The test is based on a 'forward-looking' approach rather than a 'look back' approach to commercial returns as the wording is clear that it will be the returns that are expected from a particular project. i.e. excluding any sunk costs.

20. The Strategy is clear that the test needs to be based on a post-tax return. The OGA considers that tax is but one input into the objective calculated expected value, and as such forms part of the objective test rather than based on the subjective view of any one company. As part of the evaluation, the OGA would normally first take a high level approach to this, but will look at the company's own data if there was for example a significant point of disagreement or lack of clarity.

Understanding the project

21. Whether a project achieves a SECR will depend on geological, engineering and commercial factors, and the risk and uncertainty of that data. The OGA will make every effort to gain as full an understanding of the project and its risks as possible in assessing whether a project achieves a SECR in the context of the Strategy.

22. The OGA will therefore work closely with the companies involved in the project (notably with the project operator but also with others if differences of opinion exist) and will seek their view of the inputs to the SECR test. Experience has shown that with diligent, objective analysis a common view of inputs and their risk profiles can be reached, and so allow an expected or risk weighted analysis to be made. However, where differences of view remain, the OGA will determine the project inputs based on what it considers appropriate given all the relevant circumstances of the project.

Summary

23. The OGA considers that the guiding principles for whether a project achieves a SECR for the purposes of the Strategy are:

    a) in relation to the expected return of the specific project under consideration;

    b) based on an expected post-tax return on a forward-looking basis; and

    c) one which determines whether an efficient company would consider the expected post-tax return to be satisfactory.

5. The SECR test – OGA proposals

24. In consideration of the principles set out above, the (draft) guidance provides a test which the OGA will apply to a specific project when assessing whether it achieves a SECR for the purposes of the Strategy.

Framework

25. The OGA recognises that companies will use their own approaches, metrics and hurdles when deciding whether to undertake a project. The approach set out for consultation below describes the basis on which the OGA, for the purpose of the Strategy, would assess whether a given project can objectively be considered to achieve a SECR. Whether a project passes the SECR test will likely be only one factor in the consideration as to whether and how the OGA proceeds to use its powers.

26. While companies use a variety of measures of value and return in their decision making, the OGA observes that, understandably given their underlying economic validity, Discounted Cash Flow (DCF) analysis coupled with Profitability Index (PI) are an almost ubiquitous part of the industry's economic evaluations of investment projects. In the light of this, the OGA considers that these methods should form the basis for assessing expected returns with respect to the SECR test.

27. For these methods to provide an objective test of reasonable return that is useable in practice, clear quantitative parameters are required as inputs, namely (a) the discount rate which will be applied to a project's cash flow and (b) the PI hurdle applied to assess whether the return is SECR.

28. Therefore, the measures and parameters, set out for consultation as the basis of a SECR test and explained in more detail below and in the (draft) guidance in Annex 1, are

    i. **For Exploration and Production projects:** whether the expected probability weighted Net Present Value (NPV)[9] of the project, using a set discount rate (X% nominal) is positive and achieves a Discounted Profitability Index (DPI) of Z or greater

    ii. **For infrastructure projects:** whether the expected probability weighted NPV of the project, using a set discount rate (Y% nominal) is positive and achieves a DPI of Z or greater

29. The OGA would normally consider that a project which passes these hurdles would achieve a SECR for the purposes of the Strategy.

[9] For more complex projects where there are multiple potential outcomes it will be appropriate to take a probability weighted average of the NPVs of various scenarios. This can be expressed as the Expected Monetary Value (EMV) of the project.

30. Through this consultation, the OGA is seeking views of the appropriateness and sufficiency of these measures and parameters as a basis for the SECR test.

a) Discount rates

31. The OGA considers that project cash flows and associated economic metrics should be derived in nominal, rather than real terms[10] for a practical test and to avoid additional complexity. This is because tax calculations are conducted in nominal terms. Nominal post-tax cashflows should, by extension, be discounted using a nominal discount rate.

Distinction between E&P and Infrastructure discount rates

32. The OGA considers it appropriate to estimate discount rates for different types of projects with regard to the systematic risk (i.e. macroeconomic or market correlated risks) that the projects are exposed to. In general, it is not considered appropriate to adjust the discount rate for other project or company specific risks that can be mitigated through project risk mitigation or diversification of investments. These other diversifiable risks should instead be reflected directly in unbiased project cash flows.

33. The OGA recognises that in practice companies are likely to apply a corporate discount rate. However, specifically for the purposes of a practical and objective test the OGA proposes that discount rates will be set based on the type of project in question. As different types of projects will have different exposure to systematic risks, the draft guidance distinguishes between the two types of projects set out below, applying a generic discount rate to each type:

(i) exploration and production projects; and

(ii) infrastructure projects.

34. In this context, the OGA considers that exploration and production projects are any investments or activities where the primary purpose of the project is to find and/or produce hydrocarbons, and infrastructure projects are any other supporting investments or activities. A more detailed description of the distinction is provided in the (draft) guidance.

Discount Rates

35. The OGA proposes setting the risk adjusted discount rates for the categories set out above with reference to the Weighted Average Cost of Capital (WACC) of companies that, in general, undertake projects of similar nature and levels of risk. The WACC is the rate of return that investors require for investing in a company and reflects the systematic or market correlated risks which cannot be mitigated through project specific means.

36. Market evidence[11] was used to calculate the indicative WACC ranges of Exploration and Production (E&P) and integrated companies operating in the UKCS and similar jurisdictions. For E&P companies, the range put forward for nominal, post tax WACC is 6.9-8.3%, for integrated companies a range of 5.0%-6.5% and for pipeline companies a range of 4.9-7.2%.

[11] To inform the proposed discount rates to be used for the two types of project set out above, the OGA was assisted by analysis provided by Oxera Consulting LLP and drew on Oxera's North Sea Samples for E&P and integrated companies, and from wider samples for pipeline companies.

37. The OGA considers that the above referenced WACCs of E&P companies are likely to be reasonably representative of the risk adjusted discount rates applicable to exploration and production projects (as, by definition, E&P companies carry out largely exploration and production projects) and that the above referenced WACCs for both integrated and pipeline companies are likely to be reasonably representative of the risk adjusted discount rates applicable to infrastructure projects (which will include both pipeline projects and other non-E&P projects).

38. Therefore the OGA seeks views on the following discount rates for the categories as set out above:

- exploration and production projects: a value to be within the range of 6.9 – 8.3% nominal
- infrastructure projects: a value to be within the range of 4.9 – 7.2% nominal

39. The OGA recognises that, when deciding whether to undertake a project in practice, companies may choose to uplift the discount rate to cover for any other risks they have not captured in the cashflow analysis. However, for the purposes of an objective and practical test it is appropriate to apply discount rates calculated on the basis of companies carrying out similar projects. As such these figures provide a reasonable representation of the systematic risks of projects in these categories based on market evidence.

b) Investment hurdle

Discounted Profitability Index

40. The SECR assessment is based on whether an efficient company would consider the expected post tax return to be satisfactory, not the subjective view of a relevant person undertaking the project. When the NPV of a project is positive, the expected return of the project is in principle satisfactory and would support the Principal Objective of MER UK.

41. However, the OGA acknowledges that efficient companies will be subject to capital constraints and consequently may be unwilling or unable to invest in all projects with a positive NPV due, for example, to the scarcity or prioritisation of financial resources, labour and managerial capacity. The profitability of projects and the ratio of returns to the investment are therefore recognised to be important considerations for an efficient company when selecting which projects to carry out under capital or other constraints.

42. An efficient company would want the investment to pass a certain profitability hurdle and the OGA considers the Discounted Profitability Index (DPI) – the ratio of NPV and Present Value (PV) of the investment, discounted at the same rate - as being the appropriate metric for this.

Hurdle

43. Project screening criteria are commercially sensitive and the OGA has limited evidence before it on DPI thresholds. As noted, in principle, any NPV positive project (i.e. DPI >0.0) would be satisfactory. However, given it is necessary to take capital rationing into account, a practical value for the purpose of this test will normally lie above this. The OGA considers that an appropriate threshold would likely be in the range of 0.2 – 0.3, and proposes this range for consultation.

6. Consultation Questions

Discount rate

1. Do you agree that, because SECR is based on a post-tax expected return, and tax is calculated in nominal terms, it is most appropriate to use nominal discounted cash flows and by extension set the discount rate on a nominal basis?
2. Do you agree that there should be a separation between:
   (i) Exploration and production projects; and
   (ii) infrastructure projects

and if so, that separation is sufficiently clear and provides an appropriate balance between providing a practical test, while acknowledging the variance of systematic risks present in different projects?

Please provide quantitative evidence to support your response.

3. The range of figures put forward for the discount rates to be applied in the context of an efficient company are based on calculations from market evidence on the WACCs of companies which, in general, carry out projects of a similar nature and level of risk to those categories set out above. Do you have any evidence on the most appropriate value?

Please provide quantitative evidence to support your response.

Post-tax cash flow

4. Do you have any comments on the proposed approach in relation to any other inputs to the calculation for expected post-tax return as set out in paragraphs 18-21 of the (draft) guidance?

Please provide quantitative evidence for your response where appropriate.

Satisfactory Return

5. As set out in paragraphs 40 – 43 of the consultation document, the OGA considers that the Discounted Cash Flow and Discounted Profitability Index is the appropriate practical and sufficient metric to assess the satisfactory return of a project, and is putting forward for consideration a DPI threshold value in the range of 0.2 – 0.3 for whether a project is considered to achieve a SECR for the purposes of the Strategy. Do you agree? If not, what metric or threshold do you consider to be an appropriate measure?

Please provide quantitative evidence of sufficiency, practicality and objectivity in support of your response.

Other comments

6. Are there any other important parameters or inputs you think should be included in an OGA SECR test, which may increase accuracy while still allowing it to remain as a practical and objective test?
7. Do you have any further comments on the matters set out in this consultation?

Please provide quantitative evidence in support of your response where appropriate.

7. Regulatory Impact Assessment and Equality Impact Assessment

The OGA has a general duty under the Equality Act 2010 in carrying out its functions to have due regard to the need to:

- eliminate unlawful discrimination, harassment and victimisation;
- advance equality of opportunity between different groups; and,
- foster good relations between different groups.

Further details can be found at https://www.equalityhumanrights.com/en/equality-act/equality-act-2010.

8. Annex 1: (Draft) Guidance: MER UK Strategy establishing whether a given investment or activity achieves a satisfactory expected commercial return (SECR)

[Note the metrics and parameters used in this draft guidance are subject to the outcome of the consultation and are illustrative].

Introduction

1. In the context of maximising economic recovery in the UK continental shelf (MER UK), the aim of this (draft) guidance is to provide a clear analytical framework and a practical test to establish whether a specific investment or activity (project) achieves a SECR for the purposes of the MER UK Strategy (the Strategy), based on an objective assessment of whether the expected return could be considered satisfactory by an efficient relevant person (company).

2. In circumstances where a company does not wish to invest in a project that would nevertheless achieve MER UK, the Strategy follows an approach of “use it or lose it” and the company is obliged to seek alternative funding or to divest themselves of the asset. If, after a reasonable period, the company has been unsuccessful in these marketing efforts but the project passes the SECR test then the company is obliged to relinquish the licences related to the asset.

3. This (draft) guidance sets out how the OGA will normally consider such matters and is not a substitute for any regulation or law and is not legal advice. It is intended that the guidance will be kept under review and be revised as appropriate in the light of experience and developing law and practice and any change to the OGA’s powers and responsibilities. If the OGA changes its guidance in a material way, it will publish a revised document.

4. The SECR test should be viewed by investors as a reasonable and predictable safeguard to be applied by the OGA for the purposes of the Strategy rather than as a mechanism to force activity on fundamentally uncommercial projects, which is neither the intention of the OGA nor would this be allowed under the Strategy.

5. The SECR test was introduced in the Strategy as a safeguard for investors for the use of the OGA and is not intended, nor will it be used, as a mechanism to set limits on levels of return on investment. Neither is it intended to introduce an industry standard for commerciality – companies will continue to use their own measures of subjective satisfactory return to make decisions on whether or not to invest in projects. The separate safeguard in paragraph 4 of the Strategy also provides independently of the objective SECR test, that where a company chooses to delay or not undertake investment or funding because the company itself considers the return insufficient the OGA must discuss with the company before taking any enforcement action.

6. In undertaking economic evaluations of upstream petroleum investment projects, it is expected that companies operating in the UK Continental Shelf (UKCS) will use the Discounted Cash Flow (DCF) method. The DCF method is fundamentally an analysis of a project's expected future cashflows, which are derived from input assumptions on a series of costs and revenues over the lifetime of the project. The discounted cashflows can then be used to generate a range of economic metrics which illustrate the attractiveness a project in terms of its expected profitability.

7. All projects are to be evaluated on a point-forward basis with the aim of assessing the post-tax economic viability of the investment based on expected future cashflows. Relevant inputs therefore include the expected market value of the resources which could be recovered and the expected resource cost of their extraction, where costs include both capital and operating costs but exclude sunk costs, which do not reflect current use of resources and are therefore not relevant to the decision on whether to proceed with the investment.

The test

8. The definition of SECR, as provided in the Strategy, is: "an expected post-tax return that is reasonable having regard to all the circumstances including the risk and the nature of the investment (or other funding as the case may be) and the particular circumstances affecting the relevant person".

9. In general, and having regard to all the circumstances, a project will be considered to achieve a SECR for the purposes of the Strategy if it passes the hurdle relevant to the type of project below:

i. For Exploration and Production projects: whether the expected probability-weighted Net Present Value (NPV) of the project, using a discount rate of X% nominal is positive and achieves a Discounted Profitability Index (DPI) of Z or greater

ii. For Infrastructure projects: whether the expected probability-weighted NPV of the project, using a discount rate of Y% nominal is positive and achieves a Discounted Profitability Index (DPI) of Z or greater

10. The three stages to the test are: (i) determine the type of project (and therefore which test applies); (ii) estimate the probability weighted post-tax return of the project at the appropriate discount rate; and (iii) calculate whether the Discounted Profitability Index (DPI) of the project is equal to or greater than Z.

Determining the type of project

11. Exploration and production projects are any investments or activities where the primary purpose of the project is to find and/or produce hydrocarbons, and infrastructure projects are any other supporting investments or activities. The OGA considers that exploration and production projects are in general subject to greater uncertainty and therefore systematic risk than infrastructure projects.

12. The table below sets out, for a range of investments and activities, examples of the type of projects and their classification:

13. The type of the project determines the discount rate which will be applied to the project:

- exploration and production projects: X% nominal; and
- infrastructure projects: Y% nominal.

Estimating the post-tax return

14. The metric for estimating the expected post-tax return is the Net Present Value (NPV) of the project

15. The NPV can be defined as the present value of all future incremental cash flows associated with a project discounted at an appropriate risk-adjusted discount rate.

Exploration & Production	Infrastructure
Exploration wells	New pipelines
Appraisal Wells	Pipeline maintenance and workovers
Developments	Replumbing existing production
Platform	Well interventions
FPSO	Well workovers
Subsea tie backs	Change over of electronic submersible pumps (ESPs)
Infill wells	Debottlenecking

16. The mathematical expression used to calculate NPV can be set out as follows:

$$NPV = \sum_{(t=0)}^{n} \frac{CF_t}{(1+r)^t}$$

Where:

CF_t is the post-tax cash flow (Revenue - Cost-Tax) at time t

r is the discount rate (i.e. X% for exploration and production projects, Y% for infrastructure projects)

n is the total number of years (project lifetime)

17. For more complex projects where there are multiple potential outcomes as a result of risks and uncertainties related to technical and financial inputs it will be appropriate to take a probability weighted average of the NPVs of the various scenarios. This can be expressed as the Expected Monetary Value (EMV) of the project.

Estimating the nominal post-tax cashflow (CF_t)

18. Project cash flows will be assessed in terms of future cost (including tax) and revenue components over the lifetime of the project, which when combined give the net cash flow associated with the project. The cash flow components will in practice be developed by companies and determined by various technical and economic assumptions such as projected oil and gas prices, production profiles, taxation, capital expenditure, operating expenditure, decommissioning expenditure, inflation and exchange rates.

19. The OGA will normally consider company generated input assumptions to the project cash flows and assess them in terms of their objectivity and reasonableness.

20. It is expected that a robust assessment should be made of project cash flows and that the breakdown of costs and revenues should be at a sufficiently disaggregated level of detail to ensure that tax can be calculated correctly.

Tax treatment

21. The OGA will initially consider tax treatment typical for the project under consideration. Where this treatment does not reflect the position of the relevant person and the tax treatment is the deciding factor as to whether the project achieves a SECR for the purposes of the Strategy, then further analysis drawing on the detailed tax position of the relevant person may be undertaken, including asking for any relevant information under the OGA's Energy Act 2016 information gathering powers.

Calculating the discounted profitability index

22. The project will in general be considered to achieve a SECR for the purposes of the Strategy if it has a Discounted Profitability Index (DPI) of equal to or greater than Z.

23. The mathematical expression used to calculate the DPI is set out as follows:

$$DPI = \frac{NPV}{I}$$

Where NPV (or EMV) is defined in paragraphs 15-17 above, and

I = Investment or Expected Value (EV) of Investment where an EMV is calculated, discounted at the same rate as project cash flows.

Annex 2: References to SECR in the Strategy

1. The Annex to the Strategy defines satisfactory expected commercial return as:

   "an expected post-tax return that is reasonable having regard to all the circumstances including the risk and nature of the investment (or other funding as the case may be) and the particular circumstances affecting the relevant person".

2. Introductory paragraph (d) to the Strategy sets out context as to the inclusion of the safeguard in the Strategy that:

   "compliance with the Strategy will 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 or activity. Such a 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".

3. Paragraph 3 of the Strategy states that:

   No obligation imposed by or under this Strategy requires any person to make an investment or fund activity (including existing activities) where they will not make a satisfactory expected commercial return on that investment or activity.

4. Paragraph 4 of the Strategy states that:

   "This paragraph applies where this Strategy (read in accordance with paragraphs 2, 3, 5 and 6) requires a relevant person to make an investment or fund activity and that person intends either:

   a.) to delay that investment or funding; or

   b.) to not undertake that investment or funding,

   because it will not produce a return which they consider to be sufficiently high.

   Where this paragraph applies, the OGA must discuss the situation with that relevant person before taking any enforcement action in relation to that decision".

5. Paragraph 30 of the Strategy states that:

   "relevant persons must allow others to seek to maximise the value of economically recoverable petroleum from their licences or infrastructure including by divesting themselves of such licences or assets to other financially and technically competent persons who are able to recover economically recoverable petroleum".

6. Further, paragraph 34 of the Strategy provides that:

   "Where after a reasonable period the relevant person is unable to secure alternative funding or to divest themselves of the asset then, if the recovery of maximum value of economically petroleum would achieve a satisfactory expected commercial return they shall relinquish the related licences".

8. Annex 2: Response coversheet

To: SECR Consultation

YOUR DETAILS

Name:

Company/Organisation:

Position:

E-mail address:

Address:

Representing:

CONFIDENTIALITY

Please tick below if you consider any part of your response is confidential, giving your reasons why:

Nothing		**Name/contact details/position**	
Whole response		**Company/organisation**	
Part of the response			
If there is no separate annex, which parts?			

If you want any part of your response, your name or your organisation to be kept confidential, can the OGA still publish a reference to the contents of your response including (for any confidential parts) a general summary that does not disclose the specific information or enable you to be identified?

YES / NO

DECLARATION

I confirm that the correspondence supplied with this coversheet is a formal consultation response that the OGA can publish, except as indicated above.

However, in supplying this response, I understand that the OGA may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations.

If I have sent my response by email, the OGA can disregard any standard e-mail text about not disclosing email contents and attachments.

Name:

Signed (if hard copy):

Oil & Gas Authority

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