Oil & Gas Authority

SECR Consultation

OGA presentation to OGUK

February 2018

Topics

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1. Why we’re here
2. Why we need guidance/when will it be used?
3. Background/MER UK Strategy
4. How we got here and proposals
5. How best to respond
6. Summary

Why we're here

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1. To listen

- Want to hear views
- Opportunity to share thoughts
- No final policy statements

2. Clarify intent

- Clarify aim of consultation –open consultation looking for evidence
- Set out proposals
- Opportunity to ask questions
- Guide on what we're looking for in responses

Why is this guidance needed?

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- SECR is a safeguard ***for industry*** when not intending to undertake a project
- No obligation under the MER UK Strategy where there is not a SECR
- Need more clarity on how OGA will assess whether there is a SECR
- Want to work through principles in open, transparent manner with consultation rather than in “heat of the moment”
- Acknowledge there will still be particular circumstances to consider in any individual case

When will the SECR test be used?

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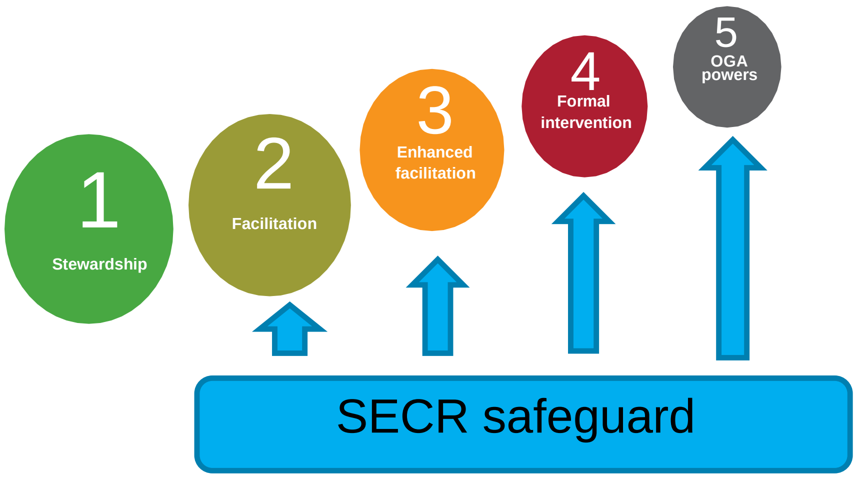
- SECR is a safeguard ***for industry*** when not intending to undertake a project
- We already have a process in place for exercise of OGA powers – and the SECR safeguard will be a consideration within this process

Licence relinquishment from MER UK Strategy a backstop

Many earlier opportunities to resolve issues and have other non MER UK tools eg FDP/licence determination

SECR within the process



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Background/MER UK

Economically recoverable in relation to petroleum means those resources which could be recovered at an expected (pre-tax) market value greater than the expected (pre-tax) resource cost of their extraction, where costs include both capital and operating costs but exclude sunk costs and costs (such as interest charges) which do not reflect current use of resources. In bringing costs and revenues to a common point for comparative purposes a 10% real discount rate will be used

- i.e. market value greater than resource cost of extraction
- Does not include any “sunk” cost
- Tax not included
- Uses 10% discount rate for purposes of bringing costs and revenues to a common point

Safeguards

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- **Prohibited conduct**

Obligations do not allow conduct prohibited by legislation or common law (including OGA obligation to act reasonably)

- **Investment or funding for benefit of another party**

May require reasonable contribution from other party to carry out activity

- **Investor confidence**

Benefit to UK must not be outweighed by damage to investor confidence

- **Insufficiently high return**

*OGA must discuss before any enforcement action if delaying or not undertaking investment/funding because **they** consider return insufficient*

- **Satisfactory expected commercial return**

No obligation will require any person to make investment or fund activity where they will not make a satisfactory expected commercial return

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SAFEGUARD

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How we got here and proposals

DECC Consultation

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Consultation:

- Consultation on draft MER UK Strategy sought views on clarity of SECR

Industry responses:

- 11 respondents felt more clarity was needed on SECR with only 1 respondent replying that enough clarity was already provided

- 5 stated economic assumptions used should be made clear

- 3 respondents said SECR should be subjective

Government response:

- "OGA needs to rely on an objective test…"

- Provided final definition: *"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.*

Clarifying SECR

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- **OGA and industry require clear grounding whether investment or activity that may be required achieves a SECR**
- **Needed as a safeguard on obligations under the Strategy– *not* as a trigger to require activity**

Factors
Which factors do industry take into account?

Metrics
Which evaluating metrics are used?

Hurdle rates
What rates are considered commercial?

Objective
What would an efficient operator do?

Lifecycle
Apply to activities across lifecycle

Oxera findings - estimating return

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Industry approach	Appropriate
Use a mixture of metrics: NPV, IRR, EMV	NPV and EMV most appropriate to capture different sizes of projects
Tend to use a common discount rate	Discount rate based on systematic risks of the investment under consideration – cf WACCs
Rely on more conservative cash flow estimates for more risky prospects	Cash flow forecasts unbiased – risk should be incorporated explicitly in the analysis
Qualitatively consider any value of delaying decision	Could be done quantitatively, but can be appropriate to do qualitatively

Oxera findings – commercial return

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Industry approach	Appropriate
Various heuristics – including a PI threshold	PI appropriate metric to use
Tend to use a common threshold	More appropriate for threshold to be driven by various factors of the project

Factors identified:

- Incumbent or potential company has undiversified investors
- Significant “real option” value of project
- Capital is constrained across the industry

OGA proposals

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What we want

- Useable and clear
- Objective
- Apply across lifecycle
- Reasonable
- Align with industry
- “efficient” operator

What we learned

- NPV and PIs
- Corporate discount rates
- Project discount rates appropriate - WACCs
- No established hurdle rate
- Highly variable

Proposals

- NPV – verify industry cashflow
- Discount rate: use relevant WACCs
- E&P: 6.9-8.3%; Infrastructure: 5.0-6.5 6.5% (Nominal)
- PI: 0.2 – 0.3
- *but* – have regard to all circumstances of project

OGA intent

- Understand some concerns around consultation and purpose
- Hope consultation helped clarify purpose
- **NOT** looking to set an industry rate of return
- Objective test required to be able to use powers (as set out in Government consultation response)
- Using an open consultation to seek quantitative evidence from industry
- Will still have regard to particular circumstances of projects so no numbers cut and dry
- SECR just one safeguard – will also have safeguards of investor confidence and requirement to discuss where company subjectively feels return not satisfactory for them.

How to respond

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Useful	Not useful
Evidence • Evidence based responses most useful to inform policy • Evidence on WACCs, metrics used, hurdles used • Evidence/input on cashflow calculations	**Outside scope** • Opinion outside of the scope of the consultation
Constructive views • Any input on how best to quantitatively assess cashflows etc • Suggestions to refine approach to objective assessment	**Misunderstanding** • Conflation of objective SECR and separate subjective safeguard of OGA discussing where company considers the return insufficient • Responses related to setting a regulated rate of return

Summary of proposals

1. Assessment based on discounted cash flow analysis – NPV/EMV

2. Fixed discount rate applied based on type of project to ensure objectivity

3. Discount rates based on WACCs of companies carrying out projects of same type

4. 6.9-8.3% (E&P) 5.0-6.5% (Infrastructure)

5. Usually SECR if NPV/EMV>0 **and** P/I > a fixed hurdle

6. Proposed fixed hurdle of 0.2-0.3

7. But will also consider particular circumstances of the *project* (not company) to determine if project is SECR

Consultation questions (brief)

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1. Do you agree appropriate to use nominal discounted cash flows and set discount rate on nominal basis?

2. Do you agree with separating between project types of: (i)E&P and (ii)infrastructure?

3. Do you have any evidence on appropriate values for discount rates?

4. Do you have any comments on proposed approach/inputs to calculation of expected post tax return?

5. Do you agree DPI is appropriate metric and figure in range of 0.2-0.3 an appropriate hurdle?

6. Are there any other important parameters or inputs?

7. Any further comments?