Oil & Gas
Authority

Satisfactory expected commercial return (SECR)

OGA response to the 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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General information

Purpose of this document

This document sets out the Oil and Gas Authority's ('OGA') response to the consultation on the "Satisfactory Expected Commercial Return" ('SECR') safeguard. This consultation was conducted between 13 December 2017 and 1 March 2018.

Consultation reference:
https://www.ogauthority.co.uk/news-publications/consultations/2017/consultation-on-satisfactory-expected-commercial-return-safeguard-secr/

This response issued 22 August 2018

Territorial extent

The offshore petroleum-licensing regime has UK extent. Offshore petroleum licences are awarded for areas in the UK's territorial waters and the UK Continental Shelf.

Additional copies

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Quality assurance

This consultation was carried out in line with the government's consultation principles. If you have any complaints about the consultation process (as opposed to comments about the subject of the consultation) please address them to:

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Introduction and background

1. This document summarises feedback received during the OGA's consultation[1] on the Satisfactory Expected Commercial Return ('**SECR**') safeguard and sets out the OGA's position in consideration of the points raised.

2. The consultation was conducted between 13 December 2017 and 1 March 2018. A list of respondents can be found at **Annex One**.

3. The consultation sought respondents' views on the OGA's approach to assessing the SECR safeguard as set out in the Maximising Economic Recovery Strategy for the UK ('**the Strategy**'), and was used to gather evidence and work through any potential concerns in an open and transparent manner.

4. The Strategy came into force on 18 March 2016 and created a legally binding Central Obligation – to take the steps necessary to secure that the maximum value of economically recoverable petroleum is recovered – along with several legally binding Supporting Obligations, on industry and the OGA. This was to enable the principal objective, established in Section 9A of the Petroleum Act 1998, of maximising the economic recovery of UK petroleum ('**MER UK**'), to be met[2].

5. In brief, the Strategy defines economically recoverable petroleum as petroleum where the market value is greater than the pre-tax hydrocarbon resource cost of extraction, excluding any sunk costs, and using a 10% real discount rate to bring costs and revenues to a common point[3].

6. The obligation to maximise the value of economically recoverable petroleum is not absolute, as the Strategy includes a number of safeguards, which may be summarised as follows:

i. Paragraph 2 – no obligation permits or requires conduct which would otherwise be prohibited by or under the law, including the OGA's duty to act reasonably;

ii. Paragraph 3 – no obligation to make an investment or fund activity where there will not be a satisfactory expected commercial return (SECR);

iii. Paragraph 4 – prior to taking enforcement action regarding a MER UK activity, the OGA must first discuss the situation with the relevant person;

iv. Paragraph 5 – where a relevant person is required to invest in infrastructure or fund an activity for the benefit of another person, they may require a contribution to the associated costs that is fair and reasonable in all the circumstances; and

v. Paragraph 6 – no obligation requires any conduct where the benefits of the conduct are outweighed by the damage to the confidence of investors in exploration and production projects in the UKCS.

7. The OGA's SECR guidance produced following this consultation provides guidance as to how the OGA would normally assess any representation from industry that the SECR safeguard should apply under the Strategy.

[1] https://www.ogauthority.co.uk/media/4505/secr-consultation-final.pdf

[2] https://www.ogauthority.co.uk/media/3229/mer-uk-strategy.pdf The Central Obligation is that "*relevant persons must, in the exercise of their relevant functions, take the steps necessary to secure that the maximum value of economically recoverable petroleum is recovered from the strata beneath relevant UK waters.*"

[3] The full definition of economically recoverable in relation to petroleum in the Strategy is "*those resources which could be recovered at an expected (pre-tax) market value greater than the expected (pre-tax) resource costs 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.*"

Summary of responses and OGA response

8. The OGA received 21 responses to the consultation. This included sixteen operators, three trade bodies, one consultancy and one university. The list of respondents can be found at Annex One.

9. Overall, respondents welcomed the consultation and supported the introduction of guidance to clarify how the OGA would assess any representation from industry that the SECR safeguard should apply. In developing the guidance, the OGA has carefully balanced the need for an objective and project-specific SECR with the comments, accommodating much of the feedback to improve clarity and avoid ambiguity where appropriate.

General comments and question seven:
Do you have any further comments on the matters set out in this consultation?

10. In addition to answers to the consultation questions, respondents also included general comments in answer to question seven and in separate commentary. These could be grouped into three main categories:

- the objectivity of SECR
- the practicality of the proposed approach
- unintended consequences resulting from the proposed guidance

The objectivity of SECR

11. Nine respondents suggested that the proposals either did represent, or could be interpreted as representing, a change to the legal definition of SECR provided in the Strategy or to the intention of government when introducing the definition.

12. These respondents felt that either the introduction of the concept of an "*efficient company*"; the statement in the consultation that "*the OGA would normally give little weight to circumstances that would not affect an efficient company contemplating the project*"; or by seeking to assess SECR with reference to a simple economic test, was at odds with the definition of SECR provided in the Strategy.

Practicality of the proposed approach

13. Nineteen respondents said either that it was not possible for SECR to be simplified into a generic test, or raised concerns that such an approach understated the importance of project specific risks. Respondents felt it was important to recognise the wide variety of risks that projects face and sensitivity analysis in dealing with such risk. Some of these respondents raised further concerns that the proposed approach failed to account for the wide variety of metrics that companies use.

14. Two respondents stated that as SECR is the industry's safeguard against MER UK obligations in the Strategy, it was unlikely to be used often in practice and that any figures set now could be out of date by the time the guidance would be used. Three respondents raised concerns that arguing with the OGA over what they considered arbitrary metrics represented an unnecessary drain on people and money.

Unintended consequences

15. Twelve respondents felt that the proposals could be misinterpreted as the OGA setting a regulated rate of return; or that the guidance could be misunderstood which would lead to unintended consequences of creating a disincentive to invest.

16. Two respondents suggested that setting figures could lead to an unintended consequence of being used to drive government policy in other areas such as tax.

Requests

17. Six respondents requested confirmation that the guidance does not amend the Strategy, and wider information on the OGA's expected processes in enforcing MER UK according to the Strategy and the status of the guidance and SECR within such process.

OGA response

Objectivity

18. The OGA notes respondents' comments on the objectivity of SECR and the Minister of State for Energy's response[4] to a question on SECR during a debate on the Energy Bill on 28 January 2016. In addition, the OGA notes that the government set out in its later summary of responses to the consultation on the Strategy that: "*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*"[5].

19. Further, as discussed in the consultation document, such an objective test for SECR is appropriate in this context – for example, in the context of the use it or lose it obligation, i.e. "*that a person choosing to not proceed with a particular investment or activity must allow others to seek to maximise the value of economically recoverable petroleum from the licences or infrastructure, including by divesting themselves of such licences or assets*".

20. The OGA notes respondents' concerns about references to an "*efficient company*" in the consultation document and how the 'efficient operator' term has been used in different regulatory contexts and that it seemed to cause some confusion among respondents. The SECR guidance no longer makes reference to such a term, noting that the OGA's review of a project where the SECR safeguard has been raised will include an assessment of whether the company's views on inputs such as technical analysis, timeframes and assumptions are reasonable and that lifecycle costs have been reduced as far as possible in accordance with paragraph 29 of the Strategy, which may include assessing and verifying a company's cost and technical inputs.

21. Further, the OGA is not attempting to introduce a one size fits all test. The SECR guidance will clarify that, in addition to the numerical assessment, the OGA will also, as required by the definition of SECR in the Strategy, have regard to all the project specific factors and have extensive discussions with operators where it is appropriate to do so.

22. The OGA maintains that for an objective SECR assessment, the circumstances to have regard to are those specific to the project rather than the inherent characteristics of the company (e.g. level of debt). However, in acknowledgement of points raised by respondents, and the requirement in the definition to have regard to particular circumstances affecting the relevant person, the OGA has added clarifying remarks in the guidance.

[4] https://hansard.parliament.uk/Commons/2016-01-28/debates/c7f8a756-c340-40a9-a110-a1f58d8bd554/EnergyBILL(Lords)(ThirdSitting

[5] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/498128/MER_UK_Strategy_government_response_FINALdocx.pdf

Practicality

23. The OGA acknowledges respondents' concerns around the suitability or even possibility of reducing whether a project achieves a SECR to a simple numerical test or tests. The OGA fully recognises that:

- companies will continue to use a wide range of metrics as suited to them for their own purposes and decision making
- individual projects are subject to a wide variety of risks, and
- it is not necessarily possible to simply conclude with a single numerical assessment whether a return would be satisfactory or not.

24. In parallel to the numerical assessment, the OGA will also take a pragmatic approach having discussions with the company throughout a SECR assessment process. In addition to the safeguards included in the Strategy, there are likely to be many earlier opportunities to resolve any potential MER UK conflicts, for example through Field Development Plans and licence stewardship discussions.

25. In acknowledgement that each individual project has its own particular risks, the guidance has been amended. Instead of having one or two pre-defined discount rates, the OGA has introduced a range within which an appropriate discount rate may be set. Further detail on the discount rate range is provided in response to questions two and three.

Unintended consequences

26. The OGA has noted respondents' concerns that the draft guidance could have been misinterpreted. The guidance has been amended and states upfront that it does not set or seek to set a rate of return across industry.

27. The SECR guidance also makes clear that it is *guidance* to the legally binding Strategy and does not seek to amend in any way the definitions in the Strategy.

28. As requested by some respondents, the guidance also provides some background as to how the OGA envisages SECR to be raised by industry in live cases through the Stewardship process to seek to provide context and comfort to industry.

> **Question one:** 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?

29. Thirteen respondents agreed that a nominal basis was a logical and appropriate approach given SECR requires a post-tax assessment.

30. One respondent disagreed, noting that "*economically recoverable*" in the Strategy was defined on a real discount rate basis. Another respondent expressed concern that a nominal discount rate did not include a company's view on inflation.

31. Seven respondents raised the point that setting a nominal discount rate meant that input of inflation assumptions was necessary. Three of those respondents felt that individual companies' inflation assumptions should be considered in any SECR assessments. In addition, two of those seven felt the OGA should set out their own assumptions on inflation from reputable sources.

OGA response

32. The OGA considers that it should not make a practical difference whether nominal or real discount rates are used in assessments of whether a project is SECR, subject to inflation assumptions, providing that project cash flows are expressed on a consistent basis.

33. The OGA recognises that companies may use either real or nominal basis in their own internal assumptions or in some instances a combination of both. In consideration of the broad support from respondents, the OGA considers that a nominal basis is appropriate for an assessment of SECR, which is defined in the Strategy as being on a post-tax basis.

Question two: Do you agree that there should be a separation between:

(i) exploration and production (E&P) 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?

34. Five respondents agreed that there was a difference in risk between exploration and production ('**E&P**') type projects and infrastructure type projects. One of those respondents felt there could also be a further separation between exploration projects and production projects.

35. Conversely, two respondents disagreed that infrastructure projects were in general lower risk than E&P projects, citing that in some instances there can be a reliance in infrastructure projects on un-appraised E&P projects.

36. Eighteen respondents suggested that assigning the risk to a project based on a broad classification was too simplistic and did not adequately consider the heterogeneity of individual projects. Respondents pointed out that an infrastructure project may have elements with risk more akin to E&P or vice versa.

37. One respondent stated that, because there would likely be range of differences on input variables, separating into two classifications was an unnecessary complication and that a universally applicable single test would be most beneficial to all parties.

Question three: 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?

38. Ten respondents reiterated the view that a single, or pair of, discount rates was too simplistic for the heterogeneity of projects and projects should instead be reviewed on a case by case basis.

39. One respondent said that by setting a discount rate the OGA did not recognise the fact that different companies may take different approaches to assessing projects, for example flexing either the discount rate or other metrics in their internal analyses on project risks. Another respondent raised concerns that the range proposed did not adequately reflect company specific factors such as debt profiles or industry preferences.

40. Two respondents raised concerns with the practicality of objectively calculating the Weighted Average Cost of Capital ('**WACCs**') of companies carrying out projects on the UK Continental Shelf ('**UKCS**'). One respondent disputed the general principle of WACCs as an appropriate proxy for discount rates. The other respondent raised concerns that WACCs require many subjective assumptions.

41. Some respondents gave their views on the ranges of discount rates proposed:

- Oil and Gas UK commissioned a report from NERA Consulting which provided ranges of 7.6-17.9% for E&P and 6.6-15.1% for pipelines – four respondents felt these ranges were more representative than those proposed by the OGA
- one respondent supported the ranges proposed by the OGA, provided they were subject to rigorous analysis
- four said the ranges provided were too low
- two suggested 10% nominal was a reasonable *rule of thumb*
- three suggested a 10% real discount rate (which could be converted to a nominal rate with an inflation assumption) would be more appropriate due to consistency with the rate used for the definition of economically recoverable petroleum in the Strategy
- two respondents questioned how a discount rate lower than that defined for *economically recoverable* reconciles with SECR being a safeguard
- one respondent provided their own analysis of ranges: 8.3%-11.1% for oil and gas companies, and 6.7%-8.8% for infrastructure companies
- one respondent said their analysis on cost of debt and cost of equity provided ranges of 6.5-9.7% and 7.9-51.1%.

OGA response to questions two and three

42. The OGA acknowledges that, owing to the heterogeneity of projects within the UKCS, it may be overly simplistic to assign one of two distinct discount rates in the guidance.

43. The OGA acknowledges that in making their own assessments, companies may choose to vary different metrics to account for their risk. The SECR guidance is not seeking to tell companies how to make their own assessments, and instead is seeking to set out a practical approach whereby the OGA may assess whether a project can achieve a SECR, while also considering the circumstances as required in the SECR definition.

44. The OGA agrees that each project will carry a variety of different risks, and so when looking to establish what the risks of a project are, setting one immovable discount rate does not adequately cover all the relevant considerations.

45. The OGA does consider it appropriate for the non-diversifiable (systematic) risks of a project to be reflected within the discount rate set with reference to the WACC, with diversifiable project specific risk captured by the company within the cash flow analysis.

46. The OGA considers that the discount rate for projects in the UKCS should be within the range of 5% to 12.75%, in nominal terms at the time of publication[6]. This range reflects a combination of current market evidence on the WACC of companies representative of those undertaking projects in the UKCS, and the nominal terms equivalent of the 10% real discount rate as defined in the Strategy. Throughout the SECR process the OGA will consider the evidence provided by the companies, and recognises that there may be facts specific to each project to indicate an appropriate discount rate outside of such a range.

47. It will be for the company to demonstrate and fully evidence where in the range the project lies. The OGA accepts that individual projects are subject to a wide variety of risks and the OGA will engage in discussions with the company throughout the process with regard to the appropriate discount rate to be applied.

[6] The top of the range will be determined by inflation at the date of the assessment. A real discount rate can be converted to nominal terms using the formula: $r = (1 + i)(1 + p) - 1$, where r is the nominal discount rate, i is the real discount rate, and p is the inflation rate. Applying this formula, 10% in real terms is equivalent to 12.75% in nominal terms, using outturn CPI inflation of 2.5% in March 2018, (Bank of England, Inflation Report, May 2018).

Question four: 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?

48. Twelve respondents noted that cash flows rely on a range of subjective inputs and some of these made the point that overcoming this subjectivity would be difficult.

49. Three respondents expressed concerns over the OGA being a judge on whether inputs are objectively reasonable.

50. Three respondents stated that reviewing company cash flows for objectivity would place an undue burden on industry and/or the OGA.

51. Three respondents requested further clarity, on how the approach can consider e.g. high/medium/low cases or risk sensitivity analyses.

52. Three respondents confirmed the general forward-looking approach to cash flow analysis was appropriate, though one of these noted that in the overall SECR assessment whether a return is satisfactory needs to bear in mind the downside risks of projects.

53. Three respondents referred to macroeconomic inputs such as commodity prices, exchange rates and inflation – two of the respondents felt the OGA was not best placed to set an objective oil price, while the other respondent said that without defining these parameters there would be no consistency between valuations.

54. Three respondents addressed tax – two noted that tax will always be subjective and/or that it was not possible or desirable to set an objective tax assumption, and the other noted that tax positions will vary over time.

OGA response

55. The OGA agrees that cashflow inputs require assumptions to be made by whomever is conducting the analysis. The OGA also agrees that any analysis needs to include considerations on risk and an assessment of whether a project achieves a SECR needs to include valuations on low, middle and high case outcomes.

56. When assessing technical assumptions where the SECR safeguard is raised, the OGA is likely to use internal or third-party expert advice. In relation to economic assumptions used by companies, the OGA is likely to compare them and the robustness of the resulting economic metrics using a range of external assumptions including those set out in Table one below.

Table one: Sources of OGA economic assumptions

Assumptions	Source
Oil and gas prices	Wood Mackenzie Quarterly Valuation Assumptions, Brent and NBP, nominal prices
Inflation rates	Office for Budget Responsibility (OBR), Economic and Fiscal Outlook, Consumer Price Inflation (CPI) forecasts
Exchange rates	Office for Budget Responsibility (OBR), Economic and Fiscal Outlook, exchange rate forecasts

57. The OGA acknowledges respondents' concerns around the SECR process being burdensome. The guidance is not intended to be used as a general test for every project, but as guidance for how the OGA will usually review cases where the SECR safeguard is raised by a company.

58. With respect to tax, the guidance makes clear that the assessment of post-tax cash flow will be based around the company's own assessment of how the project will affect its tax position, which the OGA will test for reasonableness. Only if there is then a significant difference of view will the OGA request that companies fully explain their tax calculations and the specific impact on the project/activity in question.

Question five: 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?

59. Twenty respondents agreed that Discounted Profitability Index ('**DPI**') was an appropriate metric for assessing projects. Eighteen of these respondents noted that DPI would in practice not be used as a standalone metric to assess projects but is one metric which may be used among a suite of others. Other metrics quoted by respondents were: Internal Rate of Return, Payback Period, Return On Capital Employed, Debt Covenant Impact and Price Resilience/Cost of Supply.

60. Five respondents were concerned that the DPI metric (along with an NPV/EMV discounted cash flow analysis) failed to consider risk tolerances or significant downside risk; and two further respondents conveyed concerns around DPI failing to take into account timings of return.

61. Four respondents stated that DPI was only appropriate for simple, low-risk projects – or pointed out that for higher risk and longer-term projects a higher DPI would be needed than for low risk and short-term projects.

62. Five respondents said that DPI was a relative measure or that it was primarily used for ranking of projects which may be undertaken rather than necessarily assessing whether the return of an investment was satisfactory.

63. Three respondents suggested that an absolute value of return was an important consideration and two respondents recommended that as a single metric, the absolute magnitude of the Net Present Value ('**NPV**') may be more appropriate as the primary metric.

64. Six respondents directly addressed the appropriateness of the proposed DPI range:

- one said that 0.2 was insufficient
- one said that 0.2-0.3 was insufficient to compensate for a range of estimates
- two said that 0.2-0.3 was at the extreme low end of acceptable, with a 0.5 hurdle being more typical
- three said that 0.3 was a typical or historical minimum hurdle subject to other factors.

Question six: 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?

65. Nine respondents suggested that the importance of probability distributions and sensitivity analysis on risk should be given more prominence in the guidance. Four respondents suggested payback period should be included in the SECR assessment. Three respondents suggested absolute NPV should be an additional consideration. One respondent suggested including Internal Rate of Return, and another suggested that Return On Capital Employed or Free Cash Flow are also important when considering investment decisions.

OGA response to questions five and six

66. The OGA notes the points raised by respondents that DPI along with a discounted cash flow NPV or EMV analysis may not be a single sufficient metric for companies making their own decisions on whether they would consider a return satisfactory.

67. The OGA also notes the points raised by respondents that, to make a reasoned assessment of whether a project attains an objectively SECR, other factors beyond a DPI hurdle need to be considered including the timing of the project and payback period, whether the project is low or high risk, the absolute NPV value of the project, along with many other considerations.

68. The OGA agrees that, while there are many considerations on projects, applying to a SECR assessment the whole suite of metrics would add unnecessary complexity and would still not fully satisfy the need to have regard to all the circumstances by simply adding more complexity to the numerical test.

69. Based on the responses received on the figures provided for DPI, and the lack of substantive data submitted in response to the consultation, the OGA considers that the generally recognised figure of 0.3 is representative as the initial numerical assessment for SECR, unless it can be demonstrated there are facts specific to the project to indicate that a different DPI is appropriate.

70. The OGA emphasises that DPI is not an absolute test, as all the circumstances will need to be taken into account. It is useful in the context of guidance to industry on how the OGA will assess projects when companies seek to invoke the SECR safeguard.

71. The guidance clarifies the importance of considering all the circumstances and that the numbers provided should not be considered absolute values for whether a project achieves a SECR or not. The guidance also gives examples of what the OGA might take into account and what the OGA will not take into account in its considerations.

Conclusion and next steps

72. Based on the responses and evidence provided, the OGA has updated the draft guidance on which respondents gave their views during the consultation period. The OGA has published the guidance alongside this document.

73. In publishing the guidance for the assessment of SECR, the OGA is not amending the Strategy; nor setting any new tests as to what should be considered economically recoverable petroleum (which is already defined in the Strategy); nor capping the rate of return of investments or projects.

74. The guidance provides a framework for how the OGA intends to assess whether a project achieved, or achieves, a SECR. The guidance will also aid industry where it may seek to make a representation to the OGA that they consider the SECR safeguard should apply to protect them from obligations under the Strategy.

75. In addition to the safeguards included in the Strategy, there are likely to be many earlier opportunities to resolve any potential MER UK differences of views.

Annex one – List of respondents

- Addax Petroleum UK Limited
- Apache North Sea
- BP
- BRINDEX
- CATS Management Limited
- Chevron North Sea Limited
- CNR International
- ConocoPhillips (U.K.) Limited
- ExxonMobil International Limited
- INEOS Oil & Gas UK
- JX Nippon Exploration and Production (U.K.) Limited
- KPMG LLP
- Oil & Gas UK
- Oil and Gas Independents' Association
- Premier Oil
- Professor Alex Kemp, University of Aberdeen Business School
- Repsol Sinopec Resources UK Limited
- Siccar Point Energy Limited
- TAQA Bratani Limited
- Total E&P UK Limited
- Verus Petroleum