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UKCS Trends, The Wood Report & Fiscal Environment

By Chris Rachwal

Institute of Directors – 15th October, 2014

Chapter 1: Current State of the UKCS

Chapter 2: The Wood Review & State Initiatives

Chapter 3: UKCS Fiscal Environment

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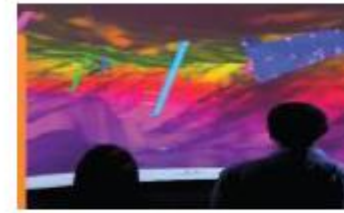
Key Themes in the UKCS

Declining production efficiency coupled with sharp decline in exploration

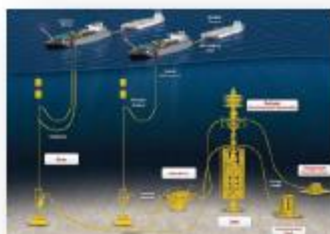
Smaller and expensive new discoveries

Upward pressure on unit operating cost



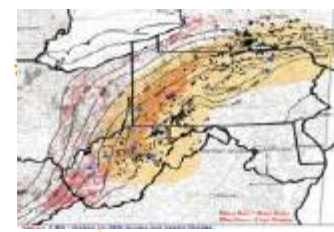
Increasing reservoir complexity

Maintenance of ageing assets



Threat of premature decommissioning

Shortage of skilled technical labor



Global Competition for Investment

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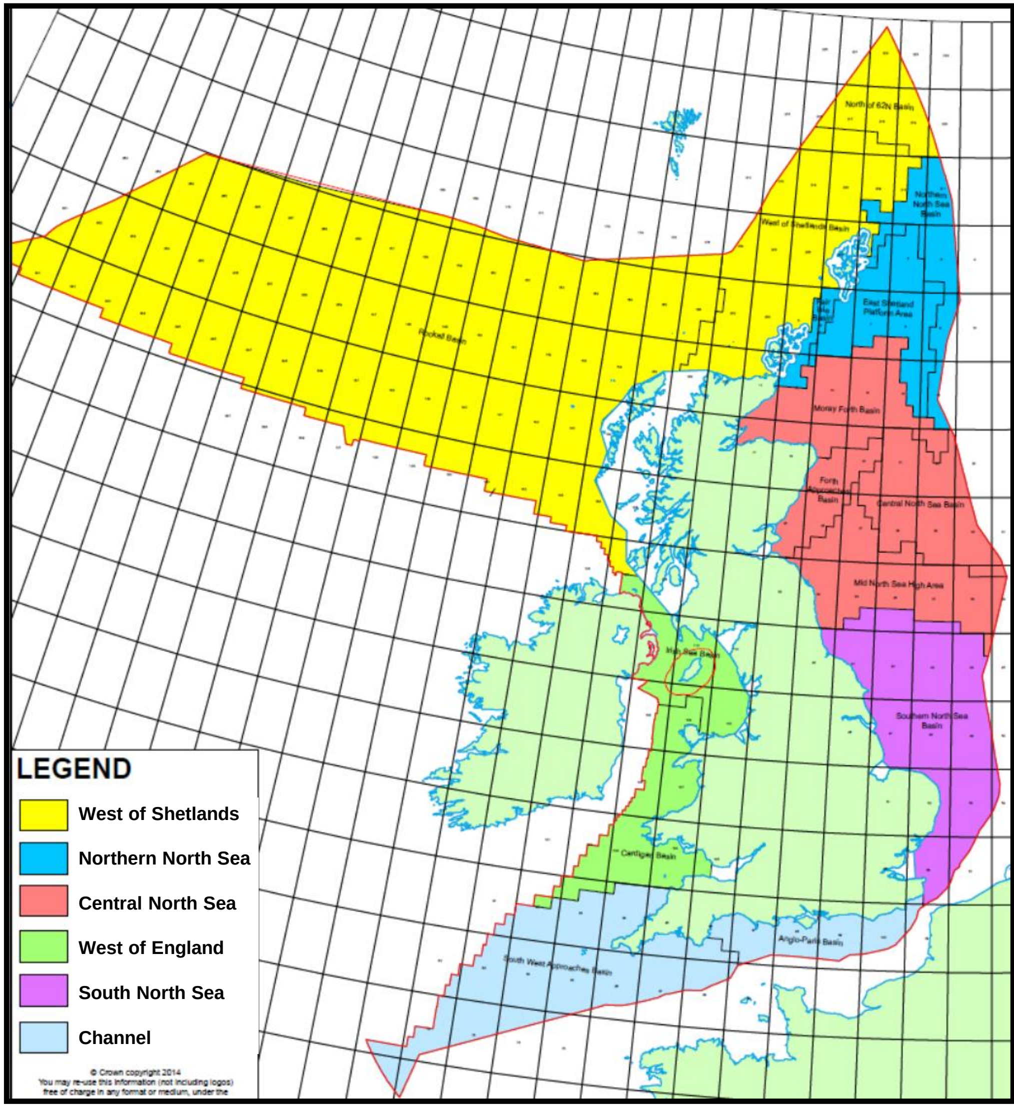
UKCS

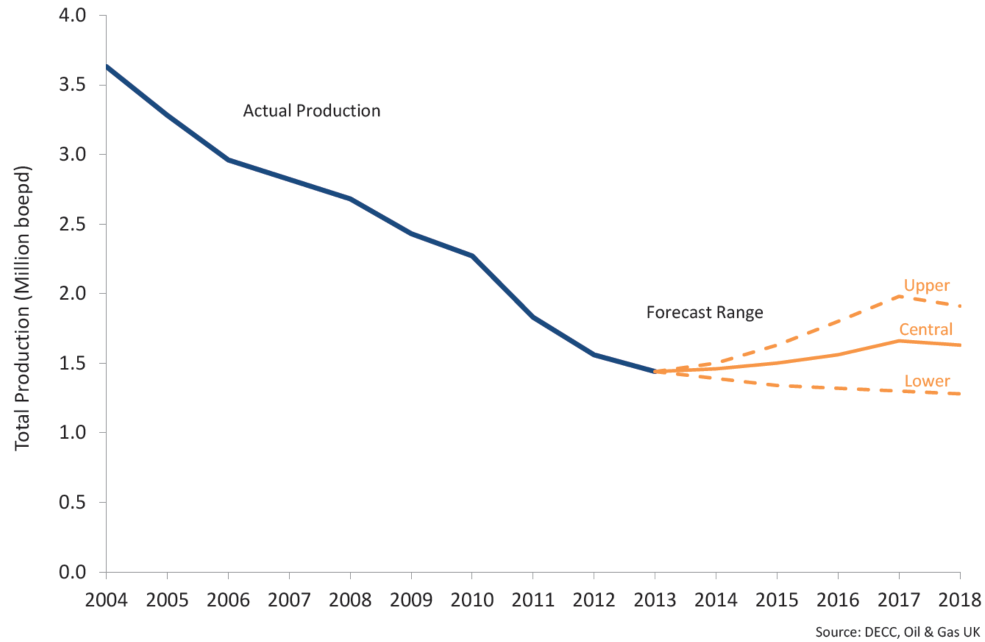
- North Sea is one of the most mature offshore basins in the world
- Still exist some new frontiers that could hold significant resources
  - West of Shetlands
  - Deep reservoirs
  - Stratigraphic plays
- Recent trends in the basin and exit of participants are risking the viability of exploring for, and extraction of, potential resources

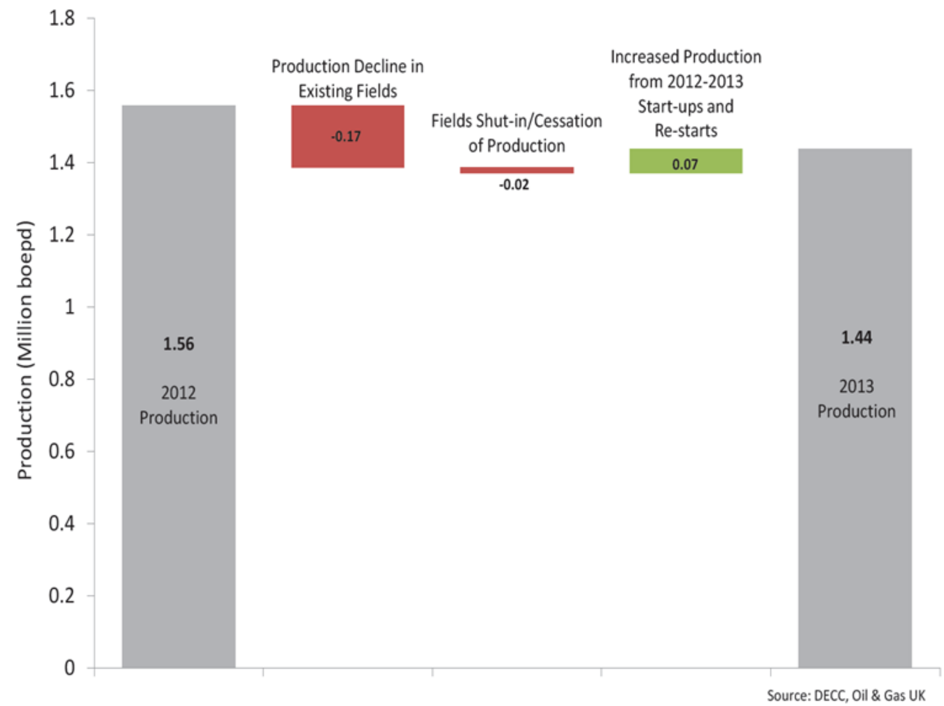


Source: DECC

Production

- 2013 Production averaged 1.44 MMboed
  - 640,000 Bbl/d of Crude
  - 106 MMcmd of Natural Gas
- Production has been on a steady decline for a decade, but is *expected* to flatten or increase over the next 2-4 years from the maturation of several new developments:
  - New Developments – Jasmine, Breagh, Mariner, Kraken, Culzean, Laggan/Tormore
- The industry concern is the ability to replace reserves and production going forward past the next couple years due to the reduction in exploration investment in the UKSC





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Wood Review

- Declining production, reserves, and exploration is the BIG issue
- Sir Ian Wood's Review in Feb. 2014 for the DECC makes 4 main recommendations:
  – Government and Industry develop a new strategy for **maximising economic recovery** from the UK Continental Shelf (**MER UK**);
  – Creating a new **arm's length regulatory body** charged with effective stewardship, **regulation, and optimization** of UKCS hydrocarbon recovery,
  – The newly created regulator taking **additional powers to facilitate implementation of MER UK**;
  – **Developing** and **implementing** importan**t (six) sector strategies.**
- Support for this study was seen both from Industry and Government and measures have been taken to immediately begin to implement the aforementioned recommendations

Wood Review Observations

- The review identifies several market trends that contribute to the current state and concern of the UKCS
  - New developments will be completed **by 2018 and capital investment is forecasted to drop drastically** after that point
  - Remaining **smaller developments require collaboration** between operators in order to achieve infrastructure and marketing efficiencies
  - **Production efficiency** has dropped to approximately **60%** from a peak of 80%+
  - Exploration is at its lowest point since the early stages of the basin, **only 150 MMboe has been discovered over the past 2 years**
  - **Infrastructure is aging** and requires both investment and optimization between operators in order to maximize their economic life
  - Technology of **late life and complex discoveries needs to be incentivized** and implemented
  - **Cost escalation** over the last decade has increased development costs dramatically
  - Competition in the global marketplace has resulted in operators and the necessary **services/technology moving elsewhere** with their resources

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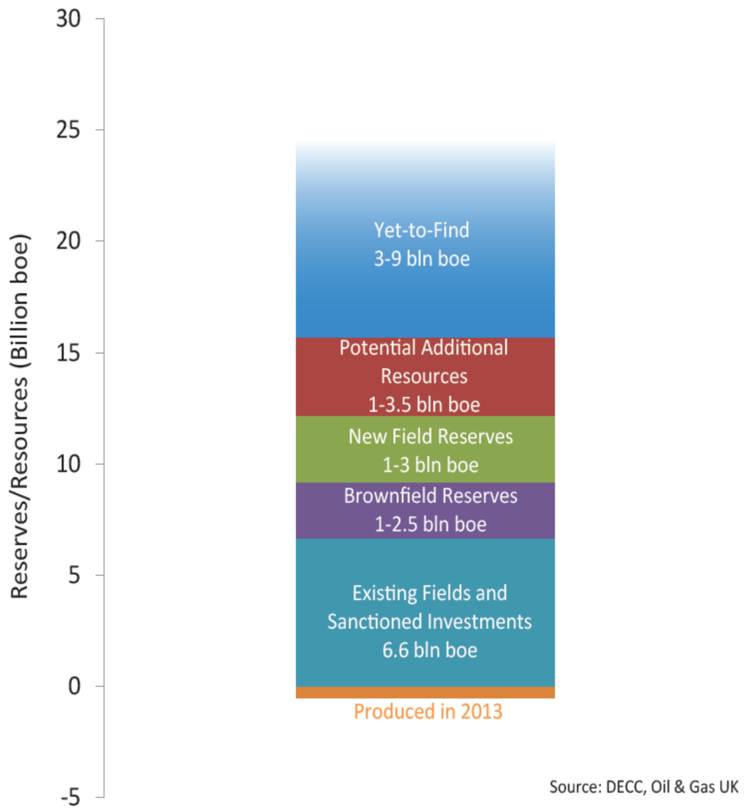
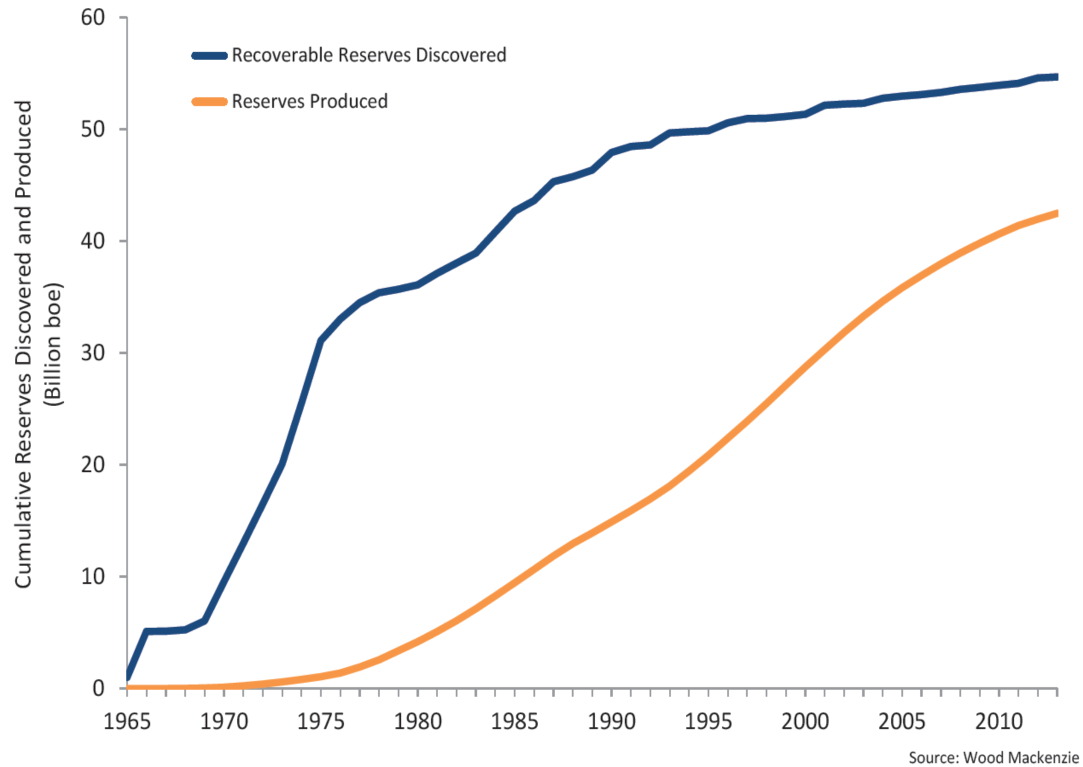
Reserves

Estimations on the total resources in the UKSC vary, but it is clear the Production has been >> Reserves replaced for 20 years





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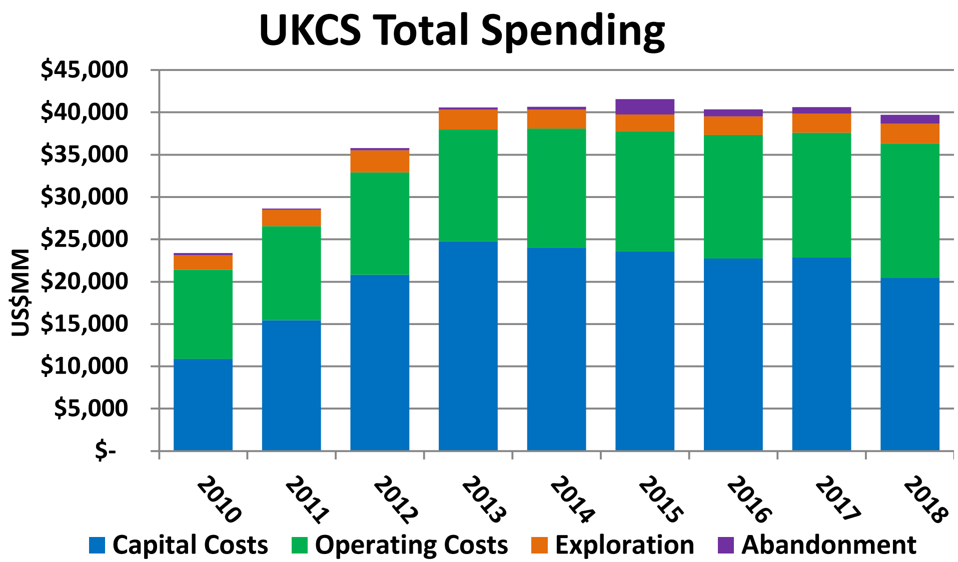
Spending

- Total spending in the UKCS has been increasing; the consensus is that 2013 will be the peak for capital investment
- Unit operating costs are expected to continue to grow significantly
- The number of exploration wells have dropped from a peak in 2008 due to:
  - Smaller find size & success rates
  - Increased Supplementary Charge (tax) in 2011
  - Increasing costs, $50-100+MM/well!
  - Alternative opportunities worldwide for offshore exploration budgets
    - Gulf of Mexico – incl. Mexico
    - West & East Africa
    - Brazil
    - Caspian
    - East Med.
    - Iran



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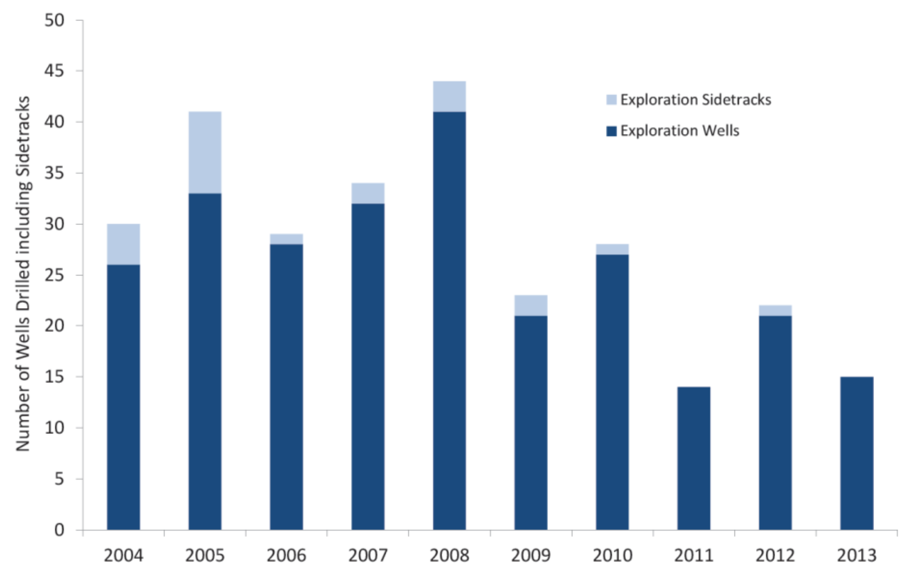

Source: DECC

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Wood Review Recommendations

- **Recommendation I**: Government and industry to develop and commit to a new strategy for Maximizing Economic Recovery from the UKCS (MER UK)
  - Meetings have already taken place between industry and the government in order to define a methodology of developing and implementing the strategy
  - Defining the MER UK is underway by the DECC as contractors are already being utilized while the new regulatory body and funding is being formed

- **Recommendation II**: Create a new arm's length regulatory body charged with effective stewardship and regulation of UKSC hydrocarbon recovery:
  - The new regulatory body has been given the name "Oil and Gas Authority" based in Aberdeen and staffing is underway
  - £3 Million budget allocated for each of the next 5 years
    - Need to attract best in class personnel, is this budget enough?

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Recommendations Continued

- **Recommendation III**: The Regulator should take additional powers to facilitate implementation of MER UK including:
  - *Facilitate* collaboration between operators
  - Contribute to dispute resolution
  - Issue sanctions and incentives
  - Attend consortia meetings
  - Acquire and provide relevant technical and commercial data

- Commentary on Recommendation III
  - The more granular involvement of government entities may bring significant advantages but can also result in **new bureaucratic delays** and stifling competition
  - The industry has always adversely responded to any un-forecasted changes to the commercial or operational aspect of existing fields, regardless if it does not result in immediate financial loss

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Recommendations Continued

- **Recommendation IV**: Develop and implement important Sector Strategies in the areas of:
  - Exploration
  - Asset Stewardship
  - Regional Development
  - Infrastructure
  - Technology
  - Decommissioning

29 Action items outlines, some of which are building on PILOT initiatives

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Current Fiscal Terms

- For new fields; UKCS currently has 2 taxes:
  - Supplementary Charge
    - 32% of taxable income, ring-fenced at the development area
    - Increased from 20% in 2011
  - Corporation Tax
    - 30% of taxable income, ring-fenced at the development area (other industries @ 20%)
    - Supplementary Charge is not deductible for calculation of tax base
  - Special tax deductions and incentives
    - Ring Fence Expenditure Supplement allows for a 10% uplift on tax losses carried forward
    - Brown Field Allowances provide for additional tax deductions in existing fields, where capital costs are expected to exceed £60/tonne
    - Decommissioning tax relief offsets for pre-cessation decommissioning expenditures
    - Other field allowances are available for specific field maturity/complexity reasons
      - Heavy oil, HPHT, West of Shetland, Marginal Fields….
- 50% Petroleum Revenue Tax (PRT) is applicable to fields approved before 1993, £1.45 Bln in 2013 – after allowances

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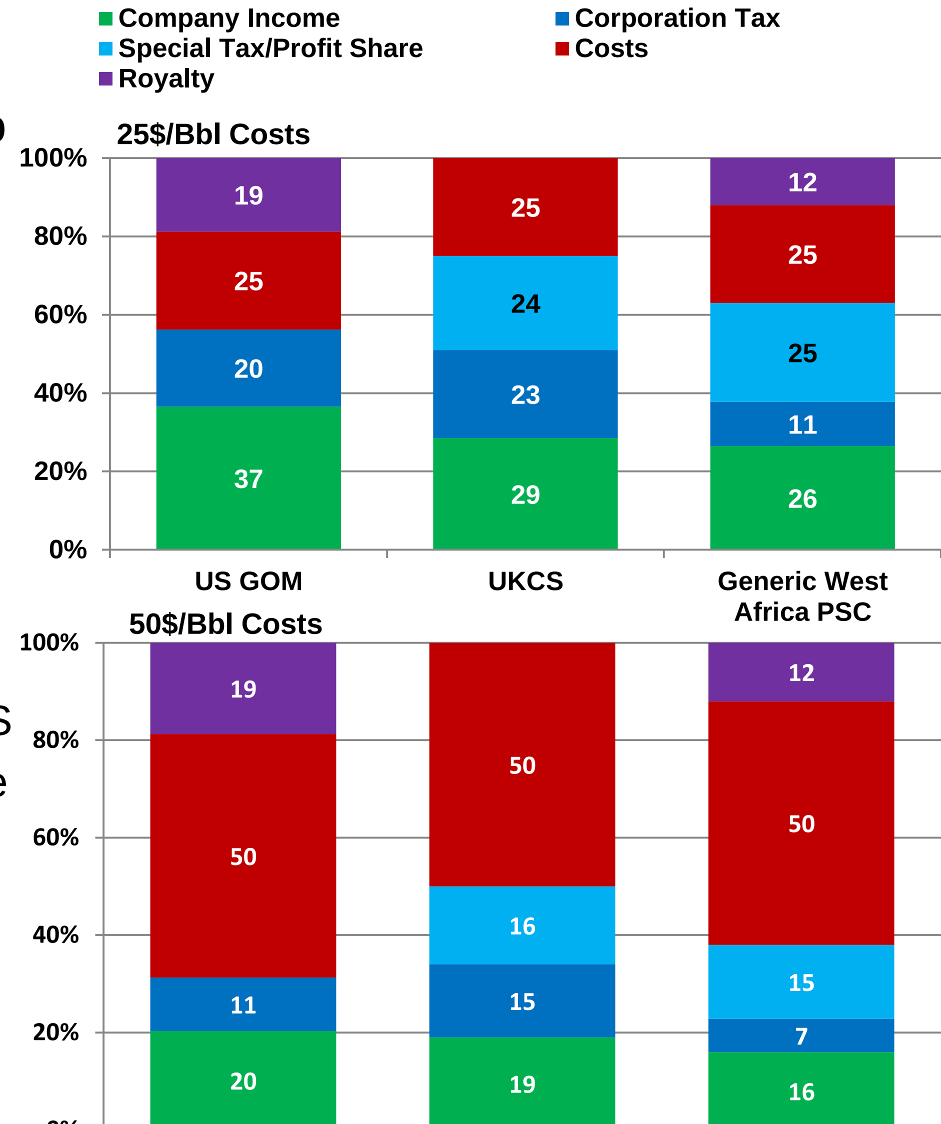
Fiscal Terms

- There is a general consensus that the fiscal terms in the UKCS are prohibitive to further investment. Though this is true to some extent the basic comparison to the right shows that the UKCS is not out of world range and in fact to some extent more resilient in a high cost environment
- This indicates that other underlying factors are significant reasons why operators are looking elsewhere for exploration:
  – Costs are comparatively higher in the UKCS
  – Industry has low expectation of finding large fields with further exploration
  – Operating liabilities or complexities are greater in the UKCS
- **Cost reduction** benefits shared with the state, for PRT fields 80% goes in tax

High Level Fiscal Term Comparison



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Thank You

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