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MANAGING DECOMMISSIONING RISKS IN ASIAN M&A TRANSACTIONS

INTRODUCTION

By the end of 2026, approximately 134 producing Concessions and Production Sharing Contracts (each, a “PSC”) will have expired in South Asiaⁱ. It is expected that 900 fields will cease production (with 45% of such fields being offshore), and 800 platforms will require decommissioning. The total cost of decommissioning is estimated at US\$100 billionⁱⁱ.

In the ordinary course of portfolio management and also to manage debt and operating costs, many of these Concessions and PSCs are currently changing hands. While the usual issues associated with any upstream M&A transaction (whether by acquisition of shares or assets) still exist, the parties involved are increasingly concerned about the allocation of decommissioning risk.

This paper discusses the various types of decommissioning risk, the decommissioning obligations that might be imposed, how deal structuring can manage these risks and considers the viable arrangements that may provide both the buyer and the seller with better long term protections.

DECOMMISSIONING RISK

The decommissioning risks that the parties seek to allocate between them fall into two distinct categories:

- (1) the cost of removing or abandoning the facilities; and
- (2) the cost of resolving existing environmental issues and the uncapped liability for potential environmental issues which have not yet surfaced.

Decommissioning Cost

The cost of decommissioning depends heavily on three factors:

- (1) how competitive the market for the provision of decommissioning services is at the time of decommissioning (i.e. whether the market is favourable to the operator or the services contractor);
- (2) the activities undertaken to decommission the facilities, which can be heavily influenced by scientific, legal or political opinions held by the regulatory agencies overseeing the decommissioning; and

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- (3) the success of the parties responsible for the decommissioning in using scientific and legal advocacy to show that more cost efficient decommissioning strategies can be equally or more protective of ecological and human health than more expensive, intrusive decommissioning efforts.

Starting upstream, the decommissioning activities to be undertaken will need to involve the following structures and raise the ensuing considerations:

- (1) Production Wells – these will need to be plugged and abandoned, but to what standard?
- (2) Drill Cuttings – depending on the level of contamination, should these be left in place, capped or removed?
- (3) Jacket and Topsides – should these be refurbished and reused, removed and disposed of onshore, toppled in situ to form an artificial reef or transported and disposed of in the deep sea?
- (4) Pipelines – should these be left in place or removed?

Typically, in Asia, neither the cost of the decommissioning services or the scope of the decommissioning work (e.g. whether to reef a jacket or to remove it – with the decision often made on a case-by-case basis following discussions with the relevant regulator) is known at the time of the M&A transaction, although they can be estimated. The parties are further hampered in their attempt to establish the extent of the risk and associated liabilities as the scope of the decommissioning obligation is unclear in many Asian jurisdictions.

Environmental Risks

The risks of environmental liability that may arise fall into two categories:

- (1) the environmental issues associated with dismantling petroleum production facilities, the type and magnitude of which are largely known from evaluation of the facilities at the time of decommissioning; and
- (2) the risk of uncapped liability for potential environmental issues associated with legal claims alleging residual contamination, which may not surface until significantly after the completion of the M&A transaction.

Examples of the known environmental risks include the removal of:

- (1) petroleum sludge from the production vessels and pipelines. These sludges can contain naturally occurring metals from the production reservoirs and naturally occurring radioactive materials as well as residues of the hydrocarbons themselves;
- (2) man-made chemicals which are used, for instance, in the electrical systems of the topsides process; and
- (3) insulation and thermal protection materials commonly found in upstream process installations.

Clearly, the safe removal and disposal of these substances is a vital part of the decommissioning process.

A particular area of potential environmental risk lies with pipelines: should they be removed or left in-situ? In either case, the pipeline in question will need to be cleared of petroleum products before it is removed or abandoned. Evidently, it will be more expensive to remove the pipelines as opposed to leaving them in-situ, but will removing them do more environmental harm than good? Pipelines installed in the shallow waters of the Asian seas often become integrated as part of the marine environment after 20 years or more on the seabed, and the removal of such pipelines inevitably damages the ecosystem. Accordingly, a strong case may be made that the environmentally responsible solution is to leave the pipeline system in place.

However, the cleaning of the pipelines is also not a perfect environmental solution, as residual contaminants may potentially remain. Some naturally occurring materials in hydrocarbon reservoirs can be absorbed into steel walls of the pipeline. This can present a serious challenge in the decommissioning strategy but does not automatically rule out in situ solutions. Well-developed scientific evidence can be used to educate agencies overseeing the decommissioning process on the advantages of in situ solutions relative to full or partial removals. Decades of work in the field of environmental remediation in countries such as the United States have produced sophisticated risk assessment tools for determining the comparative benefits of intrusive clean up strategies versus in situ approaches.

Residual contamination also poses a concern for decommissioning on onshore facilities. Some onshore production areas in Asia have been active since prior to the second world war. In these areas, which were operated prior to the development of modern environmental practices, there may have been spillages of oil or drilling mud that remain undiscovered and therefore, have not been remediated.

DECOMMISSIONING OBLIGATIONS

Following the outline on the types of decommissioning risk, the next aspect to consider is the decommissioning obligations that may be imposed on operators.

Location

Depending on the location of the facilities (i.e. onshore or offshore), the decommissioning process is governed by a wide array of international, regional and national legal sources, which are complex and sometimes vague and contradictory.

For onshore facilities, the legal framework is typically determined by: (1) national law; and (2) the applicable host government petroleum contract (e.g. Concession or PSC).

Conversely, for offshore installations, due to the migratory nature of pollution in international waters, various international and regional conventions have been implemented to address offshore decommissioning. Bilateral treaties between sovereign states will also need to be considered for petroleum facilities located in joint development areas (e.g. the Malaysia/Thailand Joint Development Area) or disputed territories, and where pipelines cross one or more international boundaries.

International and Regional Framework

The 1958 Geneva Convention on the Continental Shelf (the “**Geneva Convention**”) established the first formal rules concerning decommissioning of offshore installations, stating that “*any installations which are abandoned or disused must be entirely removed*”.ⁱⁱⁱ This provision made it mandatory for states that were a party to the Geneva Convention to remove all offshore installations at the end of their life.

In contrast, the 1982 United Nations Convention on the Law of the Sea (“**UNCLOS**”) adopted a more flexible approach to decommissioning. Pursuant to UNCLOS, total removal of offshore installations is no longer the only acceptable option from an international perspective. Rather, partial and (to a lesser extent) no removal are both possibilities provided “*any generally accepted international standards established in this regard by the competent international organisations*”^{iv} have been taken into account. While the two conventions appear to be conflicting, given that Article 311(1) of UNCLOS provides for UNCLOS to prevail over the Geneva Convention as between state parties, the position in the Geneva Convention should only apply to those states which have not ratified UNCLOS.

The International Maritime Organisation Guidelines and Standards for the Removal of Offshore Installations and Structures on the Continental Shelf and in the Exclusive Economic Zone (the “**IMO Guidelines**”), while not legally binding, are generally accepted as the international standards referred to in Article 60(3) of UNCLOS^v.

In addition, a number of regional conventions have been developed globally to work alongside the international conventions^{vi}. While no regional conventions on decommissioning has been adopted in Asia, the ASEAN^{vii} Council on Petroleum (“**ASCOPE**”) is seeking to establish a coordinated and sustained effort to address regional decommissioning problems. In 2013, ASCOPE published its Decommissioning Guidelines, which is intended to be consistent with international law and regulations and in compliance with the national legislation of each member.

The attempts of the various states to agree on a common benchmark for decommissioning is admirable. However, as these standards are only imposed on the contracting parties to the conventions (i.e. the various states), national legislation remains “*the most important tier of decommissioning legislation*”^{viii} for operators that conduct petrol operations to determine their decommissioning obligations.

National Legislation and Host Government Contracts

Decommissioning obligations are subject to variable degrees of regulation in countries across the world – from the United States, where there are entrenched laws and regulations, to Asia, where the decommissioning industry is still in its infancy and legislation is scant.

In addition to obligations specified in national legislation (if any), an operator must also look into its Concession or PSC to determine its decommissioning duties. Historically, the Concessions and PSCs awarded by host governments in Asia did not address decommissioning in detail.

In light of the anticipated proliferation of decommissioning activities in Asia, decommissioning obligations in Asia have been under scrutiny, resulting in more detailed provisions emerging in Concessions and PSCs as well as in domestic legislation. It is noteworthy that many of these new laws are intended to apply retroactively, imposing additional legal and financial obligations on the existing operators.

As an illustration, Indonesia has progressively adopted specific laws and guidelines to address decommissioning obligations and liabilities:

- (1) In 1974, regulations were enacted requiring operators to dismantle disused installations in a good workman-like manner and to notify the Government of Indonesia (the “**GOI**”) before abandoning a well and any remaining materials.
- (2) Prior to 1994, PSCs awarded by the GOI were silent on decommissioning obligations. Post-1994, the PSCs awarded began to include broad site abandonment and restoration obligations on the operators, although operators would be entitled to recover such decommissioning costs through the cost recovery procedure.
- (3) Indonesia then implemented the Oil and Gas Law No. 22 of 2001 (the “**Oil and Gas Law**”), which required every PSC to contain provisions on post-mining operation obligations. This decommissioning obligation was developed further in Regulation Number 35 of 2004 (“**GR 35**”) to require operators to allocate a fund for the post-mining operation obligations.^{ix}
- (4) In 2008, Indonesia’s model form PSC was revised and imposed decommissioning obligations on the operators, requiring operators to remove all equipment and installations from the contract area in a manner acceptable to Badan Pelaksana Kegiatan Usaha Hulu Minyak Dan Gas Bumi (“**BPMIGAS**”)^x and the GOI. Subsequent generations of Indonesia’s model form PSCs have also adopted similar language.

- (5) In 2010, to supplement the decommissioning obligations contained in the PSCs, BPMIGAS introduced guidelines which specified a more detailed process for abandonment and site restoration (ASR) and the cost for such activities.
- (6) Under more recent generations of Indonesia's model form PSC, pursuant to the agreed work programme and budget of operating costs for each contract year, operators are required to set aside funds for decommissioning activities in a joint bank account in the names of both the operator(s) and SKK Migas. The funds paid into the reserve account for decommissioning can be recovered as operating costs in accordance with the cost recovery procedure under the PSC.
- (7) The latest iteration of Indonesia's model form PSC (i.e. the Gross Split PSC) introduced in 2017 does not provide for any form of cost recovery for decommissioning liabilities, making the operators fully liable for such costs.

While industry commentators have been critical of the attempts by the GOI and SKK Migas to make operators liable for decommissioning by enacting laws and regulations with retroactive effect, the increased focus on decommissioning obligations, and the desire of the GOI to impose such duties on operators, is undeniable. This trend is observed not just in Indonesia, but throughout Asia.

THE “TRADITIONAL” TRANSACTION

In view of the substantial decommissioning risk and intensified scrutiny on decommissioning obligations in Asia, both the seller and the buyer involved in an Asian upstream M&A transaction are usually keen to delineate each party's liabilities in this respect.

In traditional Asian upstream M&A transactions, the sellers and the buyers have tended to address the two issues of decommissioning cost and environmental risks (if addressed at all) in a two-part structure:

- (1) part one deals with claims arising between the buyer and the seller, and utilises a warranty, disclosure and limitation of liability structure; and
- (2) part two provides for claims from third parties and utilises either a “your watch, my watch” or “clean break” structure.

Warranty, Disclosure and Limitation of Liability

Decommissioning Cost

If the Concession or the PSC has a defined decommissioning obligation, it is common for the seller to warrant that it has complied with such decommissioning obligations and thereafter disclose what it has done in compliance of such obligations (e.g. it has started funding the decommissioning account for a certain amount). However, as the scope of the decommissioning obligation is often agreed with the relevant regulator on a case-by-case basis, the seller is unlikely to give a warranty as to whether the amount contributed to the decommissioning fund or the scope of decommissioning is sufficient. Further, the seller will typically not be liable to the buyer for breaches of the warranty to the extent that it has disclosed against such warranty.

If the Concession or the PSC does not contain a decommissioning obligation or the obligation contained therein is uncertain, the seller will usually refrain from giving a warranty in this regard.

Environmental Risks

The conventional practice is for the seller to warrant that there are no past environmental claims and thereafter, disclose any past environmental issues against such warranty. As with the position in relation to decommissioning costs, the seller will typically not be liable to the buyer for breaches of the warranty to the extent that it has disclosed against such warranty.

Limitations of Liability

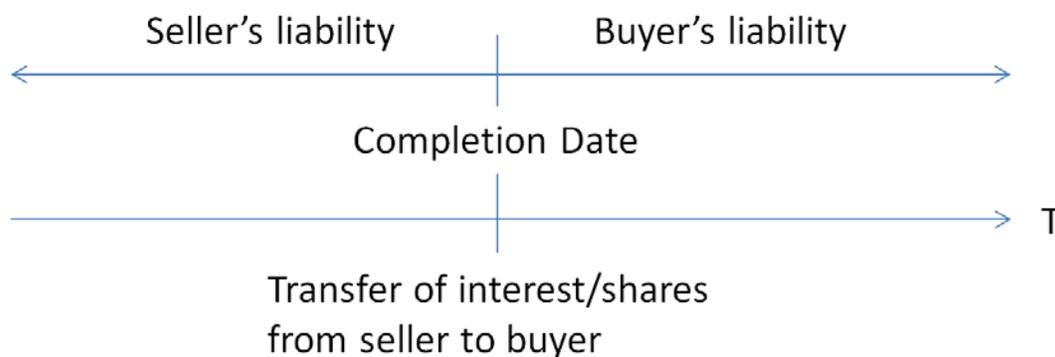
The seller will seek to cap its liability in respect of the warranties given for both decommissioning cost and environmental claims. Consistent with the position for operational warranties, this is done by fixing a maximum claim limit and restricting the period during which the buyer can make a claim.

Therefore, on the assumption that the seller makes the proper disclosures against the warranties (or, if the seller does not make any disclosures due to its lack of knowledge, the issue is not raised for the buyer's attention within the permitted claim period), then the seller is largely protected from demands on decommissioning cost and environmental claims from the buyer.

“Your Watch, My Watch” or Clean Break

While the warranty, disclosure and limitations of liability structure apportions risks between the buyer and the seller, it fails to allocate the risk of third party claims. To cover off these risks, the parties typically agree to:

- (1) a “your watch, my watch” provision whereby the seller agrees to be responsible for all costs, claims, expenses and all other liabilities in respect of, or attributable to, the interest/shares in respect of the period prior to completion, and the buyer gives a reciprocal indemnity in respect of similar claims arising after completion. This way, the seller is indemnified for claims against it by third parties arising after the completion of the transfer of the interest/shares; or



- (2) a “clean break” provision, whereby the buyer indemnifies the seller for all third party claims regardless of when they arose.

A “your watch, my watch” structure is more commonly found in farm-in agreements where the parties do not seek to agree on extensive warranties and the seller is usually confident that there has been no environmental issues (e.g. only seismic activity has been conducted in the contract area).

While the traditional approach of apportioning the decommissioning cost and environmental risks between the seller and the buyer is still valid, sellers are apprehensive that:

- (1) under a “your watch, my watch” approach, the seller remains exposed to third party claims for decommissioning costs or environmental liabilities as a buyer will seek to argue that some part of that decommissioning liability or environmental claim is attributable to the interest/shares prior to completion (e.g. the mercury contamination in a pipeline gradually built up over the life of the asset and so some part of it must have occurred prior to completion, and therefore the seller remains liable); and
- (2) under a traditional “clean break” approach, for a number of reasons described below, the seller may still be liable for decommissioning costs and environmental risks:
 - (i) **Regulation:** As in the US and the UK, many governments are increasingly concerned about the decommissioning of upstream facilities and are imposing or considering the imposition of a regime whereby the previous owner(s) the asset must fund the decommissioning if the owners of the asset at the time of decommissioning cannot fund the decommissioning costs (for whatever reason).
 - (ii) **Funding and Insolvency:** Governments are keen to ensure that proper decommissioning is carried out even if the current asset holder becomes insolvent, and the recent downturn in oil prices has highlighted this insolvency risk (particularly when coupled with regulations that look back up the chain of title to find the previous holders who can be made liable).

In some ways, the nature of the Asian upstream industry has exacerbated this risk as each asset is usually ring-fenced and held by an offshore company with no other assets. Consequently, the financial strength of such holding company, unless supported by a parent entity of substance, depends on the revenue generated by the asset. As decommissioning costs are incurred at the end of the field life when there is no income, unless a decommissioning fund has been established prior to the end of production (and such fund is sufficient), such holding company will not have the financial capacity to conduct decommissioning.
 - (iii) **The Rise of NGOs and Special Interest Groups:** Regardless of their motivation (genuine environmental protection or windfall opportunity), the number of claims for environmental harm being pursued by NGOs and special interest groups has amplified. In bringing their claims, which have become increasingly sophisticated, these groups typically target the current asset holding companies, their parent entities (on the grounds of a parental duty of care) as well as previous asset holders, particularly if they have deep pockets or are high profile (on the grounds that some of the environmental harm arose during such asset holder’s stewardship).
 - (iv) **Sustainability:** Many oil companies embrace the philosophy of sustainability as a core value, and therefore, as a matter of corporate responsibility, believe in the conscientious management of decommissioning and environmental risks.

NEW M&A STRUCTURES

To manage their liabilities in the changing climate surrounding decommissioning and environmental risks, some sellers have adapted their approach to the M&A process. These sellers broadly fall into two camps reflecting, in some ways, two opposite tactics to decommissioning and environmental risks management:

- (1) sellers who seek an enhanced “clean break” protection; and
- (2) sellers involved in ongoing decommissioning and environmental risks management.

Enhanced “Clean Break” Protections

The sellers who are seeking enhanced “clean break” protections will resist any “your watch, my watch” provisions, and will insist on a broadly drafted “clean break” indemnity provision that protects them from any future claims from:

- (1) the buyer (excluding any warranty claims expressly provided for in the agreement);
- (2) third parties, by ensuring that the buyer gives an indemnity for all third party claims (although buyers may want “step in” rights to manage the defence of these claims); and
- (3) governmental authorities (e.g. for imposed decommissioning costs or environmental penalties or fines), although an indemnity for penalties and fines may be unenforceable as a matter of policy in certain jurisdictions.^{xi}

The logical extrapolation is that the indemnity given will only be effective in protecting a seller if the buyer is an entity of substance. As mentioned previously, oil companies often isolate their oil and gas assets by having each asset held by a special purpose vehicle that has few, if any, other assets. In such a scenario, an indemnity from an entity with little financial capability is virtually worthless as the contentions for environmental harm or decommissioning cost only arise during the decommissioning process when the asset has ceased generating any revenue. Therefore, to reinforce the protection conferred by a “clean break” indemnity, sellers usually request for: (1) a parent company guarantee; and/or (2) bank bonds or other financial instruments covering a pre-determined decommissioning cost, to underpin the indemnity.

While sellers are more likely to have a “clean break” with these added protections, they come with a number of caveats:

- (1) the effectiveness of the parent company guarantee still hinges on the value of the parent company. If the parent company becomes insolvent, the indemnity also becomes largely worthless;
- (2) the bank bond must be for a fixed amount, which is difficult to evaluate given the uncertainties around the scope and cost of decommissioning. If its value is too high, then the buyer will have incurred unnecessary costs in procuring the bank bond, or if the value is too low, the seller remains potentially exposed for the additional costs; and
- (3) in some jurisdictions (e.g. the UK and US), the buyer, as part of the acquisition approvals process, must provide the government authorities with a bond or other financial security for the value of the estimated decommissioning costs. Therefore, the cost of the bank bond and the parent company guarantee, on top of the financial security to be provided to the government, are significant transaction costs that reduce the purchase price^{xii}.

Ongoing Decommissioning and Environmental Risks Management

Many sellers are realising that, in the current market:

- (1) the buyers that are interested in purchasing assets that are nearing the end of production are often specialist oil companies that focus on end-of life-assets or the smaller (and often newer) oil companies. Both types of companies will seek to function at a lower operating cost and to extend the field life, and therefore, often seek to conduct decommissioning activities at a lower cost than the seller. A common characteristic of these types of buyers is a relatively small balance sheet; and
- (2) the enhanced “clean break” structure is not particularly attractive for either the buyer or the seller. With the smaller balance sheet of its buyer, the seller continues to run the risk of residual liability, third party claims and reputational damage if the buyer becomes insolvent, and the buyer does not want to waste scarce funds on bonds and guarantees that can be better used for investments.

As a result, both the sellers and the buyers are exploring new forms of sale structures that move away from the traditional “clean break” approach. Sale structures considered thus far include:

- (1) **Retained Decommissioning Liability:** The seller sells the asset but retains the obligation to decommission the facilities (existing at the time of sale) at the end of the field life. The advantages to the seller are: (i) it can ensure that decommissioning is carried out to the standards it requires, protecting it from adverse claims; (ii) it receives a higher purchase price from the buyer as the buyer does not need to price in the uncertainty of the decommissioning obligation in its bid; and (iii) assuming the buyer does extend the field life, the decommissioning cost is deferred.
- (2) **Decommissioning Contribution:** The seller agrees to pay a fixed amount towards decommissioning at the end of field life with an agreed scope of work for the decommissioning (e.g. jacket removal rather than reefing). The advantages to the seller are: (i) it can ensure that the buyer is likely to have sufficient funds for the decommissioning; (ii) it receives a higher purchase price from the buyer as the buyer does not need to price in the uncertainty of the commissioning obligation in its bid; and (iii) assuming the buyer does extend field life, the decommissioning cost is deferred. For the buyer, if it is able to manage the decommissioning activities to a lower cost, it may make a profit on that element of the transaction.
- (3) **Insured Decommissioning Contribution:** The parties agree on the scope of decommissioning as part of the sale, with the decommissioning cost being paid at the time they are incurred by the seller, backed up by an insurance policy ensuring a fixed price for the decommissioning work. This gives the seller the certainty that the decommissioning cost is met and that it will be conducted in the manner it requires. However, it removes the upside element for the buyer who (particularly if they are a specialist decommissioning company) would seek to complete the decommissioning at a lower cost.

Notwithstanding the potential advantages, with these types of sale structures, as the asset owner is allowed to accrue a fund to pay for the decommissioning (typically by generating tax losses or cost recovering in advance the future decommissioning costs) in many jurisdictions, one of the key issues that needs to be addressed is how the accrual of the decommissioning fund can be fairly allocated between the parties contributing to it in a tax-efficient manner.

CONCLUSIONS

As the market for end-of-life upstream assets strengthens in Asia, it is likely that increasingly inventive solutions will be found to manage the associated decommissioning and environmental risks in M&A transactions. Given the wide variety of legal regimes in Asia, these will need to be carefully drafted on a case-by-case basis to ensure the parties received the bargain they negotiated for.

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ⁱ This includes the Concessions and PSCs in Brunei, Cambodia, Indonesia, Laos, Malaysia, the Malaysia/Thailand Joint Development Area, Myanmar, Philippines, Thailand, Timor Leste and Vietnam.

ⁱⁱ Wood Mackenzie on "Decommissioning and Concession expiry in Asia", presented at King & Spalding's Decommissioning Workshop held in Singapore in May 2017.

ⁱⁱⁱ Article 5(5) of the 1958 Geneva Convention.

^{iv} Article 60(3) of UNCLOS.

^v The IMO Guidelines established the following removal requirements in relation to abandoned or disused offshore installations on the continental shelf:

- (1) all installations weighing less than 4,000 tonnes (in air) and in less than 75 metres of water are to be fully removed;
- (2) for installations constructed after 1 January 1998, the complete removal requirement is extended to water depths up to 100 metres; and
- (3) for installations in deeper waters or for installations weighing more than 4,000 tonnes, partial removal is permitted.

The IMO Guidelines also advocates a case-by-case approach for partial removal, taking into consideration the effect on safety, marine environment, costs, technical feasibility and risks or injury to personnel associated with the removal operations.

^{vi} For example, in North Sea, these include the 1972 Oslo Convention, the 1991 OSCOM Guidelines and the 1992 OSPAR Convention.

^{vii} ASEAN is comprised of Brunei, Cambodia, Indonesia Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

^{viii} Morakinyo Adedayo Ayoade, "Disused Offshore Installations and Pipelines: Towards Sustainable Decommissioning (2002).

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- ^{ix} However, due to the existence of the grandfathering provisions in both the Oil and Gas Law and GR35, it is arguable that such decommissioning requirements only apply to PSCs awarded after the promulgation of the Oil and Gas Law and GR35.
- ^x The former regulator of the Indonesian upstream oil and gas industry, which has been replaced by Satuan Kerja Khusus Pelaksana Kegiatan Usaha Hulu Minyak Dan Gas Bumi (“**SKK Migas**”), the special task force for Indonesian upstream oil and gas business activities established by the GOI under Presidential Regulation Number 9 of 2013 on Management of Upstream Oil and Gas Business Activities.
- ^{xi} For example, see the Transocean/Halliburton rulings issued in November 2011/January 2012 by the US District Ct E District of Louisiana where, following the Macondo blowout, it was determined that an indemnity does not extend to punitive damages levied by the US governmental authorities for which Transocean may be liable, as the aim of punitive damages was to punish the wrongdoer and discourage future similar behavior, and such a principle would be undermined if the burden could be shifted by contractual indemnities.
- ^{xii} It is worth noting that in the US, the government has recognised that the provision of two bonds to cover the same decommissioning cost is excessive, and consequently, the seller is able to rely on the same bond coverage as the government.