



Guidance Notes on revised Industry Model Decommissioning Security Agreement

October 2015

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1. Introduction

- 1.1 The Government has, after extensive consultation with an industry working group, agreed to make available to oil and gas companies a contract (known as a “Decommissioning Relief Deed”) to provide certainty in respect of the tax relief available for decommissioning expenditure in certain circumstances, including in the event of a default by a licensee. The legislation necessary to enable the Government to make payments under such a contract, along with associated technical changes to the tax system, was included in the Finance Act 2013 (ss 80-93). It is anticipated that Decommissioning Relief Deeds (“DRDs”) will shortly become available for signature and that companies which have been active on the UKCS will enter into a DRD (or, since in most cases only one DRD is needed per corporate group, that one of their affiliates will do so)¹. As a consequence, it is the expectation of government and industry that companies will in future be in a position to enter into decommissioning security agreements (“DSAs”) which take into account the tax relief which will then be guaranteed by the Government under the DRD to a party if it is obliged to undertake decommissioning as a result of a default by a licensee. It is also anticipated that companies will negotiate changes to existing DSAs (and other agreements containing decommissioning security arrangements) to take account of such tax relief.
- 1.2 More details on DRDs and how they work are available in the Oil & Gas UK guidance on DRDs (“DRD Guidance”).
- 1.3 Oil & Gas UK’s working group on decommissioning tax relief has prepared amendments to the industry template DSA published by Oil & Gas UK in March 2009 (referred to in these guidance notes as the “template DSA”) to take account of the introduction of DRDs and these amendments have been endorsed by the Oil & Gas UK Operators Council Legal Committee. These guidance notes have been produced to assist in understanding the proposed amendments. Even those DSAs based on the template DSA tend to vary to some extent and many DSAs exist which pre-date the template DSA. Decommissioning security arrangements are also found in other agreements such as SPAs. It is considered that the amendments made to the template DSA are equally relevant to updating such DSAs and other agreements. However, particular care will need to be taken when applying these amendments to any existing agreement to take account of the particular terms of that agreement.
- 1.4 Due to a number of provisions which are only applicable to PRT paying fields, two separate DSAs have been published by Oil & Gas UK – one for PRT paying fields and one for non-PRT paying fields. The two documents are identical other than the PRT-specific clauses.

¹ See DRD Guidance – in summary, where one company within a corporate group holds a DRD, any other member of that corporate group has the right to make a claim under that DRD, therefore from a legal perspective it will not generally be necessary for a group to hold more than one DRD. However, there may be reasons why a group may wish to apply for more than one. For instance, if a group is contemplating an imminent restructuring or sale, such that a company may leave the group, it may wish to apply for an additional DRD for the exiting company or indeed, for the remaining group, if the DRD is held by the exiting company.

2. Use of DRDs in the context of DSAs

- 2.1 It is important to note that if a default occurs and a party to a DSA is required to pay for decommissioning as a result and wishes to take advantage of the guaranteed relief offered by a DRD in relation to that expenditure, a party will use its own DRD (or that of a company in its corporate group) and not that of the defaulting party. Therefore, from the perspective of ensuring that it is protected in a default, it is irrelevant to any party whether the other parties to the DSA have a DRD or not. (Some parties may take the view that whether or not a co-venturer has, or has access to, a DRD may have an impact on the risk of insolvency of that co-venturer but the working group took the view that the purpose of DRDs was not to reduce the risk of default but to protect parties if a default did occur and that requiring all parties to have DRDs for this reason was not appropriate). In practice, DRDs are likely to be in the name of the parent or major UK operating company in a group and therefore some of the parties to the DSA may not hold a DRD themselves. Consequently, there is no obligation in the DSA for each party to have a DRD, nor even for it to have access to one. However, it is unlikely that any party would agree to sign up to a new DSA on a post-tax basis (as defined in section 2.2 below) if neither that party nor anyone within its corporate group held a DRD. This is reflected in Recital E but this recital can of course be amended to reflect the circumstances of the case.
- 2.2 When amending an old DSA it is likely that parties will be reluctant to amend the calculation of security to take account of the tax relief guaranteed by the DRD (referred to in these guidance notes as a “post-tax basis”) until they have access to a DRD themselves – they may therefore decline to sign up to amendments until they or an affiliate have executed a DRD or alternatively it may be appropriate to include provisions making a move to a post-tax basis conditional on each party having a DRD. In this case a party’s concern is not that others have a DRD but that it has one itself, but the effect is that the DSA will not move to a post-tax basis until all parties either have a DRD or waive the condition precedent.
- 2.3 All DRDs are expected to be in identical form and there are provisions in the DRD to discourage the Government from amending any one party’s DRD. The DRD referred to in the DSA is therefore this standard version. The standard DRD has now been published on the HMT website² and while it remains available there the website might be referred to in the DSA – if not, then it may be appropriate to annex the DRD to identify it. However, for the reasons set out below, parties should think carefully about how to define the DRD – it may be appropriate to define it as the version available at a particular date.
- 2.4 It is possible that the Government might in future issue an Alternative Schedule to the DRD – this possibility was allowed in case in future the Government wished to offer a greater degree of relief for decommissioning than was offered in the DRD or if some technical error was found in the DRD. The mechanism of the Alternative Schedule would allow this to be made available rapidly to all DRD parties without the need for a time consuming round of deeds of

² Available at : <https://www.gov.uk/government/consultations/decommissioning-relief-deeds-increasing-tax-certainty-for-oil-and-gas-investment-in-the-uk-continental-shelf>

amendment. To protect holders from this mechanism being used to amend the DRD to their detriment, a holder always has the option of whether or not to adopt any Alternative Schedule (although this is a one-time election and once adopted, the Alternative Schedule will apply thereafter). If an Alternative Schedule fixed a technical problem or offered greater relief it is hard to see why it would not be opted into by all holders but it might be that the Schedule offered relief in such a way that some parties would be better off and others worse – for instance it might provide greater security against default but at the cost of lesser security for one's own decommissioning. Because it is very difficult to foresee what implications any Alternative Schedule might have for the calculation of security under a DSA, the DSA does not currently refer to it (except to state that the issue of an Alternative Schedule will be deemed not constitute a unilateral amendment of the DRD such as to give rise to an Adverse Tax Event) and as drafted, an Alternative Schedule would not constitute part of the defined term "Decommissioning Relief Deed" in the DSA. The DSA could be amended to provide that the impact of any Alternative Schedule should be reflected in the DSA only if all parties have elected to apply it. (It would not be appropriate to apply it to calculate the security of those parties which have elected to use it since, as explained above, in the event of their default the parties picking up that liability will use their own DRDs and if not all of the parties have elected to adopt the Alternative Schedule, it is impossible to know whether a party which picks up the liability will be using it or not.) However, the working group has opted to stay silent on this matter so that the parties would need to review the situation if an Alternative Schedule is ever issued.

- 2.5 The relief guaranteed by the DRD for situations of default (referred to in the DRD as "Imposition") is straightforward where the field is not within the scope of PRT – in these cases the government guarantees a total of 50% relief for RFCT and Supplementary Charge.
- 2.6 The situation for PRT is more complex – the government has agreed that where a default occurs, the party taking on the liability will be able to set losses against the tax capacity of the defaulting party and its predecessors. However, this tax capacity could at any time be affected by loss carryback claims by a licensee – this means there is no absolute guarantee to other parties as to how much relief they will receive for PRT. The draft attempts to minimise these risks in a number of ways, as set out further below.
- 2.7 Finally it should be noted that payment of tax relief by the government under the tax system or under DRDs will tend to be received somewhat later than payment out of the trust is currently received. The DRD allows claims to be made in relation to a chargeable period immediately after the end of the chargeable period in default cases, and provided all the correct information is provided, payment is due 60 days from the date of the claim for RFCT/SC and 120 days for PRT. If the party picking up the default is still paying RFCT/SC on other assets it will be able to reflect the offset of any losses in its periodic payments and will suffer no cashflow impact but if the party has no UK profits against which to set decommissioning expenditure it will need to fund the tax relief element and for this reason the draft proposes the inclusion of an element of bridge finance in the calculation of security to be provided and in payments out of the trust. In the calculation of security, a bridge finance amount (defined as the "Bridge Finance Factor") is calculated for each

licensee and increases the Provision Amount to be provided by that bridge finance amount – see further at paragraph 8.5 (in relation to the calculation of the bridge finance amount) and at paragraphs 10.8 and 10.9 (in relation to when the bridge finance amount may be paid out of the trust).

3. Adverse Tax Events

- 3.1 The DRD provides a significant degree of confidence to industry that the decommissioning tax relief stipulated in the DRD will be available in the event that a party is obliged to carry out or pay for decommissioning as the result of a default. However, the DRD cannot remove all risk in this regard. As noted in the DRD Guidance, it is a fact of the UK's constitutional arrangements that one Parliament cannot bind a future Parliament and therefore there is at least a theoretical risk that a future Parliament could decide to revoke the Enabling Legislation or even to legislate to annul executed DRDs (although there is no precedent for such a step). It is also possible that legal challenges over interpretation might narrow the scope of DRDs in some way or that changes to the tax rules might, deliberately or inadvertently, affect their operation. The impact of DRDs in respect of assets in the Scottish jurisdiction might also be affected if there were to be legislation or a treaty to grant independence following a positive referendum vote.
- 3.2 If an event were to occur which undermined the certainty of parties to DSAs that the relief stipulated in DRDs would be paid, then those parties reliant on the security in DSAs will wish to revert to pre-tax security. Clause 2 addresses the risk of such events and the reversion process. Because the events which might lead to such an outcome are varied, and because the risk appetites of parties to DSAs are equally varied, this clause gave rise to significant debate within the working group. There was a wide spectrum of opinion within the work group ranging from those whose primary concern in such an event was that parties facing significant exposure to decommissioning costs in the event of default should not find their security against this risk underfunded as a result of having moved to a post-tax basis, to those largely concerned with the potentially detrimental financial impact of a sudden and significant increase in letter of credit requirements facing a large number of companies simultaneously. It proved very difficult to achieve consensus around these issues and as a consequence the clause dealing with these matters is complex and contains a large number of options.

4. Definition of Adverse Tax Event

- 4.1 The first option relates to the definition of “Adverse Tax Event”. Two options are provided – one is a general definition and the other is effectively the same general definition but incorporating a non-exhaustive list of examples. Some may feel that the list is unnecessary (particularly since in most cases it is still necessary to establish that the particular event specified has an “Adverse Effect”) but others may feel that there is some advantage in making a little clearer what kinds of events, and at what stage in their progress, are intended to constitute Adverse Tax Events.

- 4.2 In addition, the concept of an ATE Risk Notice allows the parties to take cognisance of an event which has not yet taken effect but which is foreseeable – this may be particularly relevant in the context of legislation. Where legislation is proposed or introduced it has no immediate effect and there is at least a possibility that it may never become law – some may therefore believe it would be inappropriate for it to trigger an immediate reversion to pre-tax security. On the other hand, to treat it as of no significance until it becomes law is to ignore a significant risk. The template DSA therefore provides for service of an ATE Risk Notice. If it is decided (by selecting the relevant options in the definition of Adverse Tax Event) that introduction of legislation should not be an Adverse Tax Event then such introduction could instead permit the service of an ATE Risk Notice – this puts parties on notice that a change to the security provision amount calculation may be triggered, enables discussion of how that change should be addressed, and (since parties have had time to put in place banking arrangements while the legislation is debated) reduces the notice period to put amended security in place when the trigger for an Adverse Tax Event is reached. It makes sense in this two stage process to stipulate what precise point in the legislative process can trigger an ATE Risk Notice and what point triggers an Adverse Tax Event - the parties to the DSA would need to select their preferred options to achieve this. (Of course, the ATE Risk Notice may also apply to other Adverse Tax Events.)
- 4.3 Within the general definitions, there are two further options in square brackets. One is to include words “or reasonably likely to render” –these words may be appropriate if it intended that Adverse Tax Events should include matters such as draft legislation which are not yet effective. The second option is inclusion of the word “material” in relation to the “sweeper” wording. Some might argue that the first two categories of event (affecting the Guaranteed Relief or the enforceability of DRDs) are by their nature material and therefore it is unnecessary to include the word in the sweeper since an adverse effect which was not material would not be similar. It may also be argued that any impact (even a 1% reduction) in the Guaranteed Relief, would be an Adverse Tax Event and so there should in fact be no materiality restriction on the sweeper wording. Others may feel that since it has not been possible to identify any events which would fall only into the third category, it is advisable to create some sort of expectation that the type of event which is intended to be covered must be material.
- 4.4 Within the list of events in the second of the two alternative definitions, there are a number of options related to legislation. To help parties in their consideration of which options to adopt, it is necessary to have some knowledge of the legislative process. Useful information can be obtained from the Parliament website³. In brief, however, in order to become law a Bill must pass through five stages (First Reading, Second Reading, Committee Stage, Report Stage and Third Reading) in each House of Parliament before Royal Assent is granted. It is rare for a bill introduced by a majority government not to be passed although of course the government may accept amendments or be forced to concede amendments on individual clauses. Of private members’ bills only a proportion progress beyond First Reading – if they do, it usually suggests government support and therefore at this point they may be treated as equivalent to a government bill. Once a bill has reached third reading in the

³ <http://www.parliament.uk/about/how/laws/passage-bill/>

second of the Houses to consider it then enactment is essentially a formality – amendments proposed by the second house need to be agreed with the first house but the bill will usually proceed rapidly to Royal Assent. If a bill is a “money bill” (such as Finance Acts and tax legislation) it is always introduced into the Commons and if it passes all of its stages in the Commons it cannot be amended or defeated by the Lords and can only be briefly delayed. Third reading in the House of Commons is therefore usually the point at which tax changes are treated as substantially enacted for accounting purposes since in the case of tax legislation the House of Lords cannot amend or defeat the measure. It is likely, though not inevitable, that legislation to amend the Enabling Legislation or otherwise to impact DRDs would be a money bill and would therefore start in the House of Commons and not be subject to significant scrutiny in the Lords.

- 4.5 In brief, three options are given for the stage at which draft legislation would become an Adverse Tax Event:

4.5.1 The earliest is introduction of a Government Bill or Second Reading of a Private Members Bill;

4.5.2 The second option is passing at third reading – this could be third reading in the second House or, taking the view that the majority of relevant bills will be money bills and therefore introduced in the Commons, third reading in the first House;

4.5.3. The latest stage, is Royal Assent or enactment.

- 4.6 There is a further option which is that, if draft legislation is chosen as a trigger for an Adverse Tax Event then the trigger can be postponed for a period (the draft suggests 60 days). There are two reasons for this – first, it means that when legislation is introduced, there is time for industry to lobby government to persuade government of the potentially catastrophic consequences of the legislation, without those consequences having immediate effect. Second, it recognises that while introduction of legislation creates a significant risk that the legislation will come into force and therefore those in receipt of security may wish to see action taken sooner rather than later, the legislative process takes time and therefore to take action immediately may result in security being increased months before the legislation actually takes effect, so such action is postponed for a defined period.

- 4.7 If it is decided to select either of the later options within the definition of Adverse Tax Event, the earlier stages can be used as triggers for an ATE Risk Notice (see section 5.5 below).

- 4.8 There are two concerns around any potential move towards Scottish independence and they are addressed in paragraphs (c) and (d) of the second definition of Adverse Tax Event. It is possible for contractual obligations of the government to be assigned by agreement or by operation of law – the latter would be more likely (and has been done in the past on independence) as addressing all of the Government’s obligations individually is likely to be impracticable. The first concern is therefore that in drafting any such transfer, DRDs are not expressly referred to and it is unclear on the drafting whether the obligations under the DRD in relation to expenditure on Scottish assets have

been assigned to the Scottish government or not – this would give rise to uncertainty. Any legislation would therefore be keenly scrutinised by those in receipt of post-tax security under DSAs. The options in terms of legislation are similar to those discussed in section 4.4 above but independence would not be achieved through a private members bill or a money bill and it may therefore be more appropriate in the second option to pick the second of the Houses of Parliament. It is also possible that independence would be effected not through legislation but through treaty and this is also included in (c). The second risk on independence is that obligations are expressly assigned but the Scottish government indicates an intention not to be bound by those obligations or to take action to limit its obligations – this is addressed by paragraph (d).

- 4.9 In the context of the possibility of Adverse Tax Events under paragraphs (c) and (d), the working group considered whether the definition of “Tax” was appropriate if such an Adverse Tax Event did occur. Whilst most definitions in the template DSA are consistent with definitions in the DRD, it was felt appropriate that the definition of Tax in the template DSA should refer to England, Wales, Scotland, or Northern Ireland. This definition reflects the expectation that the DSA would survive following Scottish independence at which point taxes imposed by the new Scottish Government might be relevant. It was viewed that the potential impact of Scottish independence on the tax regime was too uncertain to make further provision for in the template DSA, but parties should remain live to this issue and may need to consider revising the definition of Tax in their DSAs in the event that Scottish independence were to occur.
- 4.10 Paragraph (f) of the second optional definition takes account of the potential for the Government to fail to make payments under DRDs. The exclusion is required to make it clear that such a default would not constitute an Adverse Tax Event where the failure to pay was specific to a particular party – i.e. it is a sanctioned entity and therefore the Government is prohibited from making payments to it.
- 4.11 There are also options in paragraph (g) relating to proposals to change Tax legislation which are similar to those discussed above in relation to the Enabling Legislation. It is very unlikely that changes to tax legislation or codes of practice would be an Adverse Tax Event since the entire purpose of the DRD is to “freeze” tax legislation for the purposes of decommissioning relief. However, the provision is included in case of some unforeseen impact.
- 4.12 Oil & Gas UK understand that the Government does not believe that provision of DRDs constitutes state aid and does not intend to notify them to the European Union as such. It is understood that this view is based on the fact that (except in exceptional circumstances of default which a party cannot plan for) the DRDs do not offer relief beyond that which is currently offered by the tax system. Again, however, the risk is included out of caution.

5. Process for dealing with Adverse Tax Events

- 5.1 The substantive provisions dealing with Adverse Tax Events are set out in Clause 2. The Clause enables parties who believe that an Adverse Tax Event has happened or may happen to serve a notice which will ultimately, unless the parties decide otherwise, result in the security reverting to a pre-tax basis. As discussed above, the concern around these provisions is that a reversion to pre-tax security will in many cases require parties to either put up security where they are not currently doing so or to substantially increase their security and that if this arises at short notice it is likely to cause significant financial pressure to some licensees and in some cases may even result in default under the DSA. Even if all of the companies concerned were theoretically able to fund the additional security at short notice, the pressure on banks to address requirements for increased letters of credit for numerous industry parties simultaneously could give rise to delays which could themselves give rise to defaults under the DSA. The clause seeks to strike a balance between protecting the interests of parties receiving security and not precipitating the kinds of defaults which might lead them to need to call on that security.
- 5.2 The processes set out in Clause 2 are such that, if an ATE Risk Notice or an ATE Notice is served, then unless all of the parties agree otherwise within 30 days, security will revert to a pre-tax basis (assuming that the anticipated event materialises, in the case of an ATE Risk Notice) (see Clause 2.1.6). Parties should bear in mind that by requiring unanimous approval of the parties, this effectively affords a right of veto to the party which served the original ATE Risk Notice or ATE Notice and indeed, each other party. The draft does not provide any alternatives to unanimity due to a number of additional complications which would arise (i.e. a JOA pass mark vote would not take account of Second Tier Participants, whereas a straw poll would not take account of the fact that parties with a larger percentage interest in the field will be more exposed to potential changes than parties with a smaller percentage interest), but parties may wish to negotiate alternative bases for reaching decisions. A party which is the beneficiary of security and which serves such a notice is perhaps unlikely to change its mind and so there is considerable momentum in the process towards reversion to pre-tax.
- 5.3 There are three ways in which protection may be given to those which provide security against misuse of this process:
 - 5.3.1 The first is the option in Clause 2.1 and 2A.3 to provide that notices may only be served by a party acting “reasonably” or “in good faith” and that parties must act in such a way when reaching agreement on the matters to be discussed following any such notice (see Clause 2.1.7 and 2.3.11).
 - 5.3.2 The second is the requirement in these clauses that notices must contain certain information – essentially the party serving the notice is required to give reasons for its view to promote discussion between the parties and to facilitate the discussion having a meaningful chance of addressing it in another way – such as a Limited Adverse Tax Event (see section 5.6).

5.3.3 The third is that an ATE Notice may only be served if an Adverse Tax Event “has occurred” - this means that the test at this stage becomes an objective one capable of being tested in the courts.

- 5.4 The working group considered whether disputes about whether Adverse Tax Events had occurred should be resolved by expert but there were a number of issues with such an approach. First, it would be difficult to find one expert able to give a view on the very wide ranging events which fell within the definition - an expert can always be given the power to take advice from other experts but the selection and appointment of such experts would then potentially extend the timetable. Moreover, if an event occurred, it would be likely to affect all DSAs and so many joint venture groups might be seeking expert views with the result that the most qualified experts might be deluged with requests. Further, the outcome of the issues involved is so significant that parties should seriously consider whether it would be appropriate to accept the decision of an expert from which there would be no right of appeal. Particularly where constitutional issues were concerned it was felt that the best way of resolving disputes would be a test case which would be likely to be applicable to all parties whose contracts contained the same wording or a similar concept. This does have the effect however that, if a party believes strongly that action is being taken when the event does not constitute an Adverse Tax Event within the terms of its particular DSA then its only option is to seek an injunction from the court. Optional wording has been included in Clauses 2.1.6 and 2.3.10 to make it clear that a party's right to issue court proceedings will not be prejudiced by the automatic operation of this clause. The clause does however provide that the reversion to pre-tax will not be halted until a court remedy has actually been obtained (i.e. it is not sufficient for a party simply to have issued proceedings). This is optional since parties may take the view that this is always the right of any party to an agreement and so it does not need to be stated
- 5.5 ATE Risk Notices may be served where there is concern that an Adverse Tax Event is likely to arise. If parties are concerned that including draft legislation within the definition of Adverse Tax Event is inappropriate, since that legislation may never become law, then they may choose to adopt one of the later options within the Adverse Tax Event definition but the introduction of draft legislation can then be specified (in Clause 2.1.1) as an event which justifies the service of an ATE Risk Notice. If introduction of draft legislation is within the definition of Adverse Tax Event this option can be deleted.
- 5.6 The use of ATE Risk Notices does not immediately result in any increase in security – however, it puts parties on notice that increased security may be required if the anticipated event occurs and, if it does materialise, potentially reduces the time within which increased security must be provided, since parties have had time to prepare for this eventuality. It also gives the parties an opportunity to discuss whether the event is a Limited Adverse Tax Event – this is one which does not undermine the principle of the Government's guarantee but perhaps addresses some detailed aspects of the calculation of payments under the DRD and which therefore reduces the amount of relief which is guaranteed. In such a case, the parties may agree that the event can be addressed by a change to the formula for calculating security. This may

require agreement of amendments to the DSA. See section 5.11 for further discussion of Limited ATE Notices.

- 5.7 If either an ATE Risk Notice or an ATE Notice is served then the Operator will usually be required to call a meeting to enable the parties to discuss the implications. As noted above (section 5.2), Clause 2.1.7 (in respect of ATE Risk Notices) and Clause 2.3.11 (in respect of ATE Notices) provide that unanimous agreement of all parties (whether or not they attend the meeting called by the Operator) is required to determine the outcome of the notice and sign the resulting ATE Risk Determination Notice or ATE Determination Notice within 30 days⁴ of service of the notice and if there is no unanimous agreement then the agreement will move to pre-tax security. The meeting is to be held no less than 11 days⁵ from the service of the ATE Risk Notice or ATE Notice – this allows time for Limited ATE Notices to be served – but no more than 21 days⁶ from the notice. This gives a further 9 days⁷ for all parties to finalise and agree the ATE Risk Determination Notice or ATE Determination Notice before the default option of reversion to pre-tax security kicks in. The matters to be discussed at the meeting are set out in Clauses 2.1.5 (ATE Risk Notice) and 2.3.9 (ATE Notice).
- 5.8 The working group considered whether the meeting itself should be empowered to take decisions and whether all parties should be required to send a representative but it was felt that at a time when meetings might be required for many joint ventures this was not practicable, and in any event many parties were not able to give full authorisation to representatives to reach decisions on such significant matters. Therefore template DSA requires signature of an ATE Risk Determination Notice or ATE Determination Notice, which may be done at any time within 30 days⁸ of the original notice.
- 5.9 The only exception to the requirement to hold a meeting is where an ATE Notice follows an earlier ATE Risk Notice in respect of the same event and no party takes issue with the outcome of the earlier discussion (and resulting ATE Risk Determination Notice or deemed agreement) in terms of the consequences which flow from the event. This outcome is produced by the combination of Clauses 2.3.2(a) and 2.3.7. If any party does wish to prompt a reconsideration of the ATE Risk Determination Notice in respect of the event in question (perhaps because the event which has materialised is not quite the event which was predicted or perhaps because the party wants to have another attempt to persuade parties to treat the event as a Limited Tax Event or not to do so) then it can serve a notice suggesting a different approach (see Clauses 2.3.2(b) and 2.3.7).
- 5.10 If one party serves an ATE Notice or ATE Risk Notice and other parties disagree that there has been or is likely to be an Adverse Tax Event, there is no counter-notice procedure – they will be able to express their views informally and/or at the meeting. The party which has served the notice could decline to attend the meeting to frustrate any discussion – there is therefore an

⁴ See footnote 2.

⁵ See footnote 2.

⁶ See footnote 2.

⁷ See footnote 2.

⁸ See footnote 2.

obligation on all parties to use reasonable endeavours to attend (as noted above, an absolute obligation may not be appropriate).

- 5.11 If however, an ATE Notice or ATE Risk Notice has been served and a party considers that it is a Limited Adverse Tax Event then the party can serve a Limited ATE Notice or Limited ATE Risk Notice respectively setting out how it thinks the DSA could be amended to address the event – this may be because the party which served the notice did not suggest such a solution or because the other party has a different solution (see Clauses 2.1.3 (ATE Risk Notice) and 2.3.5 (ATE Notice)). The reason for suggesting a notice in this situation is that drafting may be required to address the event and this gives the parties time to consider the drafting in advance. However, even if no party has served a Limited ATE Notice or Limited ATE Risk Notice this approach can still be discussed at the meeting – although clearly it is likely to be helpful if parties have seen the proposals in advance.
- 5.12 There is an option to prevent the Guaranteed Relief from being progressively reduced by small steps – this is to include the wording at the end of Clauses 2.1.5(c) (ATE Risk Notice) and Clause 2.3.9(c) (ATE Notice) which provides that proposals in relation to a Limited Adverse Tax Event cannot result in the relief being reduced beyond a certain threshold.
- 5.13 Whatever the parties agree following service of an ATE Risk Notice or ATE Notice, even if they agree that there is no Adverse Tax Event or that there is such an event and that reversion to pre-tax security is the right outcome, agreement must be unanimous and is recorded through an ATE Risk Determination Notice or ATE Determination Notice. If not all of the parties have signed such a notice then the default position is that the ATE Risk Notice or ATE Notice is correct and that security should revert to a pre-tax basis. Even if there was unanimous agreement between the parties that a Limited Adverse Tax Event had occurred but then the parties could not unanimously agree how the calculation of the Provision Amount should be amended to reflect the Limited Adverse Tax Event, the default is still reversion to pre-tax. This is due to the fact that the working group generally favoured certainty in outcome. An additional advantage is that if an event genuinely is a Limited Adverse Tax Event the parties will be more determined to agree amendments to avoid reverting to pre-tax.
- 5.14 The consequences of service of an ATE Risk Notice are set out at Clause 2.2. The parties will know what their security would be if they moved to pre-tax security as the Operator is already required to notify them of this amount each year under Clause 6.2. However, if the ATE Risk Determination Notice provides that it is a Limited ATE Event the Operator will need to recalculate security and notify the parties accordingly. The parties do not need to provide increased security immediately but they may be asked to demonstrate that they will be able to do so. There is no immediate remedy if they are unable to demonstrate this but the other parties will be on the alert for a default if the Adverse Tax Event does occur. The Operator will also need to circulate a deed of amendment of the DSA to provide for the different basis of calculation and anything else agreed in the ATE Risk Determination Notice. To make best use of the time before the Adverse Tax Event occurring, the deed of amendment will be agreed but not signed until the relevant Adverse Tax Event occurs – see Clause 2.2.2(b). (It could be signed with a condition precedent but this

would need to provide both that the Adverse Tax Event has occurred and that none of the Parties have objected to the treatment of it agreed at the time of the ATE Risk Notice, as they have the right to do under Clauses 2.3.2(b) and 2.3.7). To address the fact that parties may simply delay or refuse to sign the deed of amendment to avoid having to provide increased security, a provision has been included at Clause 2.4.4 that the parties will give effect to the deed of amendment until it is fully executed.

- 5.15 The Adverse Tax Event may never materialise – there is a provision enabling the parties to agree that the risk has gone. This “clears the board” so that if a similar event should occur at a later date there is no risk of confusion as to whether there is an existing ATE Risk Determination Notice which applies to that event.
- 5.16 The consequences of service of an ATE Notice are set out in Clause 2.4. If there has been a prior ATE Risk Determination Notice for the same event (or if there was no agreement such that Clause 2.1.6 applies) and no party takes exception to the consequences of such Notice or deemed agreement, then the next steps will happen quickly – as soon as the period for counter notices in Clause 2.3.7 expires. If there is no pre-existing ATE Risk Determination Notice or deemed agreement or if this is queried under Clause 2.3.2(b) or 2.3.7 then there will need to be a meeting. Within 30 days⁹ either that meeting will have resulted in agreement on an ATE Notice or it will not - if it has not, then the default position is that the Adverse Tax Event has occurred and there will be reversion to pre-tax security (see also section 5.13).
- 5.17 If it has not previously done so (because there was no pre-existing ATE Risk Determination Notice or because the positioning the pre-existing ATE Risk Determination Notice was successfully challenged under Clause 2.3.2(b) or Clause 2.3.7), and if the event is a Limited Adverse Tax Event the Operator will recalculate the Provision Amounts. The parties will already know what their security would be if they moved to pre-tax security as the Operator is already required to notify them of this amount each year under Clause 6.2. In either case, the Operator must also issue fresh invoices for the revised Provision Amount.
- 5.18 Assuming there has been no previous ATE Risk Notice the parties have a period (proposed in the template as 25 Business Days) to pay the increased Provision Amount or provide increased Alternative Provision. Beginning from the service of the ATE Notice, if the periods proposed in the template are adopted this means there should be a maximum of 30 days¹⁰ (to reach agreement or deemed agreement) plus 5 days for the Operator to issue the invoice plus 25 Business Days for payment to be made – giving the parties providing security around 10 weeks in total to arrange additional security. (See comments at section 3.2 regarding the likely pressures on security providers in such circumstances.). Failure to pay within this period will be a Default and will trigger a call on any existing security.
- 5.19 If there has been a previous ATE Risk Notice and no-one takes exception to the outcome of that ATE Risk Notice (either to deal with the Adverse Tax

⁹ See footnote 2.

¹⁰ See footnote 2.

Event as set out in the previously agreed ATE Risk Determination Notice or to revert to a Pre-Tax Provision Amount if Clause 2.1.6 applied), then this timetable is accelerated. The thirty day period is reduced to 10 days¹¹ (to allow for the service of Counter Notices) and the 25 Business Days is reduced to 5 Business Days – this is subject to the qualification that since the ATE Risk Notice was served at least 60 days have passed (so that the parties have had time to put in place contingent banking arrangements).

- 5.20 It will be apparent from the above that it would be possible to extend the timetable by provision of a Counter Notice under Clause 2.3.7– to limit (though not entirely remove) the impact of such action, where the Counter Notice results in no substantive alteration in approach, the 25 Business Days is reduced to 5 Business Days. The total time period in this case is 30 days¹² from service of the notice plus 5 days for the Operator to issue the invoice plus 5 Business Days for payment to be made.
- 5.21 Note that the failure to execute a deed of amendment within the timeframes noted in sections 5.17, 5.18 and 5.19 will not prevent these new invoices being issued – this is to prevent a party withholding its signature in an effort to prevent an increase in security.
- 5.22 If the Adverse Tax Event occurs in the autumn, the Operator may already have issued calculations and invoices for the following year - in this case the Operator will need to amend these invoices in addition to requesting additional security for the current year. If an Adverse Tax Event occurs at a point in the year when invoices have already been issued and payment is already due for the following year it may be felt unnecessary to require the licensee to increase its current security – if it cannot raise the increased amount for the following year then it will be in default from 1st November in any event and to require it to negotiate a one month increase in its current security as well as increased security for the following year creates unnecessary increased pressure on the licensee. If the parties wish to allow for this an option is set out at Clause 2.4.3.
- 5.23 If invoices have already been issued for the following year then parties may require more time for payment of the supplemental part of the invoice – the original invoice will remain due on 1st November but the supplemental invoice for the increase resulting from the Adverse Tax Event should have the same minimum payment period as an invoice for the current year (Clause 2.4.6).
- 5.24 If an Adverse Tax Event has occurred, it is possible that it may be reversed. For instance, if the event is the introduction of tax legislation then during its passage the industry may persuade government to amend it in a way which would remove its impact on DRDs. If the event is the introduction of legislation to undermine DRDs expressly, it may be defeated during its progress. If that happens, then it may be appropriate to return to a post-tax calculation of security. Clauses 2.5 and 2.6 apply two different approaches to that reversal – Clause 2.5 leads to automatic reversion to post-tax security unless the parties agree unanimously to do something different whereas under Clause 2.6 the move requires unanimous agreement. Clause 2.5 is an option which can be

¹¹ See footnote 2.

¹² See footnote 2.

adopted to address specific, identified events where the question of whether there has been a reversal is likely to be fairly unambiguous – such as the defeat or abandonment of legislation or the reversal of a court decision on appeal. Clause 2.6 addresses all other circumstances where the question as to whether an Adverse Effect has been reversed may be more arguable. Parties may take the view that reversal may never be entirely unambiguous and therefore prefer to delete Clause 2.5 and address all Reverse Events under Clause 2.6. If the Adverse Tax Event is defined as the enactment of legislation then there is no obvious later event to constitute a Reverse Event and this option should be deleted from Clause 2.5.

- 5.25 All time periods in Clause 2 are in square brackets in the template DSA. This was as a result of the working group considering that parties to a DSA may wish the overall 30 day period (referred to in sections 5.7, 5.8, 5.15, 5.17 and 5.19) to be a different period. If a different period is introduced the parties will need to give due consideration to the earlier points in the timeline to ensure they fit together and provide sufficient time for actions to be carried out. This will be particularly significant if a period of less than 30 days is introduced.

6. PRT Certificates

- 6.1 As noted above, the calculation of decommissioning relief guaranteed under DRDs for PRT fields is based on the tax capacity of the parties to those fields. PRT certificates provide a “snapshot” of that tax capacity at a particular point in time and may therefore be used, subject to certain safeguards, to assess the decommissioning relief available and therefore the security to be provided. They do not however represent a guarantee of the relief which will be available – this is a matter of the tax capacity of the relevant party.
- 6.2 Under the DRD, various parties are entitled to ask for a PRT certificate in relation to the tax position of a participator in a field subject to PRT – this includes the participator itself, an Associated Entity¹³ of the participator, any party which is concerned that it may incur decommissioning expenditure if another party defaults in the future (such as a party to a DSA wishing to work out what security to request from a Licensee), or any party which has or expects to incur decommissioning expenditure because another party has defaulted (such as a Second Tier Participant under a DSA which has been brought back by DECC to carry out decommissioning).
- 6.3 The template DSA for fields subject to PRT (Clause 4.1A) places the primary responsibility to obtain a certificate on each licensee in relation to its own interest. In many circumstances, the PRT certificate will not affect the level of security as there will be ample tax capacity to relieve all decommissioning expenditure and the new PRT Certificate will replace one tax period with 50% relief with another offering 50% relief. In other cases a licensee will be motivated to provide a certificate in order to increase its certified tax capacity and therefore reduce its security. However, there are circumstances (although they are relatively rare) in which a party’s aggregate tax capacity may be

¹³ This is a term defined similarly but not identically to the term “associated” as used in section 30 of the Petroleum Act 1998 – see the DRD Guidance for more details

reduced between one certificate and another and this motivation will not exist - this could arise as the result of the carry back of losses to an earlier period or the impact of oil allowance. Therefore, in order to ensure that security reflects the most recent available tax position, an obligation is placed on the operator to request a certificate if the licensee fails to produce one by a stated date.

- 6.4 Certificates in respect of the chargeable period ending on 30th June in any year will require parties to have submitted claims for losses for that period, which they are required to do by 31st August. At that point, HMRC is in a position to prepare certificates including details of those losses claimed but will not have completed their assessment of those claims. However, it is unlikely that HMRC would allow more losses than are claimed by the participator, and as losses erode tax capacity and therefore potentially increase security, assuming that all claimed losses will be allowed produces a conservative assessment of security – if losses are not allowed, in most cases remaining tax capacity would increase and security would reduce. HMRC has therefore agreed to provide certificates which include details of all closed periods and losses as claimed for any open periods and the template DSA calculates security based on the allowed tax position as at the end of the previous period and all losses claimed for the subsequent six months.
- 6.5 It is not yet clear by when HMRC will issue PRT Certificates – they cannot begin to prepare them until they receive claims for the most recent period and then will need to focus attention on their core task of assessing claims. While they hope that they will be able to issue certificates by the end of September, some may lag into October, particularly in the first year or two of operation of the system. This creates some tension in relation to the DSA since under the timing suggested in the standard, invoices must be issued by the operator by 1st October to allow security to be provided by 1st November. The working group considered moving this timing back to allow more time for PRT Certificates to be produced but unless the entire DSA timetable, including the validity period of letters of credit, was shifted away from the current calendar year approach (which was undesirable for a number of commercial reasons) this risked allowing inadequate time to resolve any issues over the provision of security between 1st November and 31st December and increased the risk of defaults arising during a holiday period.
- 6.6 As a practical solution to this problem, the template DSA provides for an option (in Clause 4.1A) that if the Operator has not received a PRT Certificate from HMRC by 14th September it should request one. It should also at the same time request the licensee to provide to it within 5 working days the same information as HMRC would be including on the PRT Certificate in relation to the most recent period (Preliminary PRT Information). This enables the operator to prepare its invoices using the most up to date information and send them out in a timely manner by 1st October - if the PRT Certificate appears during October (or indeed later), and there is any inconsistency with the information provided by the licensee, there are provisions for the invoice to be corrected or supplemented. If this option is selected invoices would to some extent depend on the co-operation of licensees, but there are draconian sanctions for failures to provide data, as noted below (see sections 6.7 and 6.8). If this option is not selected, the template DSA provides that the most recent PRT certificate (i.e. March) will be utilised if the September certificate has not been received.

- 6.7 If a licensee plans to carry back losses to an earlier period, such that tax capacity is reduced, there is an obligation on the licensee to notify the operator in advance so that its security can be amended and the claim cannot be made until the increased security has been provided (see Clause 4.1B). Since any such claim will erode the tax relief available to parties affected by the licensee's default, notification is crucial to ensure that the correct level of security is available. Failure to do this can result in the licensee losing all right to have PRT relief taken into account in future in the setting of its security (see 4.1D). There is provision for it to be waived by all parties by unanimous agreement.
- 6.8 Clause 4.1C reflects the fact that in an Imposition, the decommissioning costs of the defaulting party may be spread across a number of parties, primarily its co-venturers but also potentially Second Tier Participants. In this situation, the DRD provides that the tax capacity of the defaulting party should be allocated on a pro rata basis across all of the affected parties according to how much expenditure they have incurred and claims can effectively be suspended until the Government has decided how much tax capacity should be available to each party (this will allow each claim to be suspended until all claims have been received and the aggregate decommissioning expenditure is known). Clause 4.1C requires a party who has incurred Decommissioning Expenditure in an Imposition to consult with the other affected parties before making a claim against the tax capacity of the defaulting party – such consultation should speed up the process of all parties receiving any DRD payments due to them. If a party has made a claim without consultation, perhaps before it becomes clear that these provisions of the DRD are applicable, that party is required to amend its claim accordingly, if necessary by surrendering relief so that the relief becomes available to the other parties in the appropriate amounts. Again failure to do so can result in withdrawal of PRT Relief from the calculation of security.
- 6.9 The working group considered the question of whether any competition concerns would be raised by the sharing of information in this manner. The working group commissioned an opinion from CMS Cameron McKenna LLP on whether as a practical matter it would be possible to reverse engineer from a PRT Certificate or Preliminary PRT Information with any degree of accuracy the prices at which hydrocarbon products from a particular field were sold during the period covered; whether, in the circumstances, this information is likely to be commercially sensitive in that it would be of commercial value to a competitor to have the data; and if so, whether any potential competition concern would be outweighed by the advantages provided by the DRD scheme, such that any prima facie infringement could be justified under Article 101(3) TFEU.
- 6.10 The opinion concluded that:
- 6.10.1 In practice it would be extremely difficult for a competitor to extract such prices from the available profits data in a PRT Certificate or Preliminary PRT Information because even if volume information and some cost information is shared between co-venturers, each co-venturer will have some element of individual cost which will not be known to its other co-venturers. Even if costs could be estimated, because the profits contain revenue contributions from a variety of

hydrocarbon products, it would be challenging to accurately calculate the profits associated with each product stream independently.

6.10.2 Even if pricing information could be extracted it would be average pricing over a six month period and this would be very unlikely to be commercially valuable to a competitor given the great number of variables impacting the average price.

6.10.3 Even if useful data could be extracted it is likely that the limited disclosure involved is within de minimis limits so that there would be no appreciable impact on competition. If not, then there are good arguments that the disclosure is justified by the overall benefits of the DRD scheme in terms of its contribution to increasing investment in the UKCS and thereby improving the production or distribution of hydrocarbon products, and that the disclosure is likely to be indispensable to the operation of that scheme.

7. The Trigger Date and the Decommissioning Plan

7.1 It should be noted that the working group has chosen to retain the definition of Trigger Date without amendment. The Trigger Date is a date which prompts the operator to begin to prepare an annual decommissioning plan and to calculate security. In the original industry template DSA, the Trigger Date coincides with the time at which security begins to be payable. In a post-tax DSA this may not be the case. The Operator will begin to prepare a decommissioning plan at the Trigger Date (the point at which, absent any tax relief, the Net Cost of decommissioning multiplied by the risk factor, begins to exceed the Net Value of the Field). However, it is likely that for a number of years after this date, the effect of tax relief on the calculation of security will be such that no security will be payable. One reason for requiring the Operator to begin the annual cycle of calculations is so that, if for any reason there is a requirement to revert to pre-tax security, the Operator is in a position to do this rapidly, having already put in place a decommissioning plan and calculated the relevant pre-tax security amount.

7.2 Clause 4.2 sets out the information to be given by the Operator to the parties as part of the proposed plan for decommissioning - this has been amended to include PRT Certificates and information about the calculation of PRT Relief (although, when the plan is circulated in June, the most recent information will not yet be available so the calculation will be updated before invoices are issued).

8. Calculating security

8.1 Although the definition of Net Cost could have been amended to be net of tax, the working group decided it was easier to address tax relief in the calculation of the security amount. This is partly because Net Cost is global figure for the whole field and it is useful to retain this definition whereas tax relief is a matter

for each licensee. In particular, for PRT fields, each party may have a different post tax calculation which does not sit easily with a global definition. It also simplified the process of reverting to pre-tax security to address tax relief in a substantive clause rather than a definition.

- 8.2 The template DSA now provides for the operator to carry out two calculations of security, one with and one without the effect of tax relief. The template DSA provides for both calculations to be notified to the parties by the specified date (Clause 6.2) so they are all aware of what their security would be if an Adverse Tax Event did occur and there was no agreement for it to be treated as a Limited Adverse Tax Event. However, absent such a circumstance, the invoice issued by the Operator in respect of security will be the Post-Tax Provision Amount.
- 8.3 The Pre-Tax Provision Amount is identical to the calculation of the Provision Amount under the original industry template DSA. The Post-Tax Provision Amount subtracts from the Net Cost of Decommissioning (after inflation by the risk factor) an amount (TR) reflecting the tax relief which the DRD guarantees to the other parties if the licensee defaults and adds an amount in respect of the bridging finance which parties may incur while awaiting payment under a DRD.
- 8.4 TR is calculated as set out in Appendix 5, paragraph 6. The calculation is discussed further below but in essence it is very straightforward for fields which do not pay PRT – it is simply a question of multiplying the inflated net cost by the rate of RFCT/SC relief guaranteed under the DRD (50%). For PRT fields the calculation is much more complex as it needs to be based on the tax history of each licensee.
- 8.5 The bridge finance amount (defined as the “Bridge Finance Factor”) is calculated by approximating the cost of financing TR for the average period which is expected to accrue between the expenditure being incurred and the payment being received from Government. The period is slightly different for RFCT/SC and for PRT. Under the DRD, the Government has agreed that claims may be made in Imposition cases immediately after the end of the relevant 12 month accounting period for RFCT/SC or 6 month chargeable period for PRT and that payment will be made within 60 days of the claim for RFCT/SC and 120 days for PRT. Assuming that on average expenditure is incurred at the mid-point of the relevant period and allowing a month for submission of claims and resolution of any queries, tax relief or DRD payments for RFCT/SC should be received within 9 months of the expenditure being incurred and in the case of PRT 8 months.
- 8.6 The bridge finance amount is based on a notional interest rate which may or may not reflect the actual cost of finance to an individual licensee. If the licensee actually incurs decommissioning expenditure as the result of a default and its finance costs are higher, there is an opportunity to claim any additional costs out of the risk factor as discussed further below in relation to Clause 9.8 – the licensee would need to provide evidence of the additional cost. If its finance costs are lower, there is currently in the draft no provision for the licensee to repay the difference – the working group decided that to calculate the true cost of capital for a licensee was simply too complex as it would be likely that the cases where costs were lower would be those financing out of

cash flow. The risk that non-defaulting licensees may receive some marginal benefit from this rate is therefore simply one of the risks of default.

9. Default

- 9.1 The section addressing default has been amended to refer to certain new obligations on the licensee, breach of which would constitute a default.
- 9.2 In Clause 8.1.3, failure to pay an Invoice has been removed – this is because the template DSA contains very specific provisions in Clause 8.1.2 regarding failure to pay an Invoice (i.e an invoice for decommissioning) which set out at exactly which point in the process the default arises.
- 9.3 Clause 8.2 has been amended to provide a clear process of notifying the Trustee of a default.
- 9.4 Clause 8.3 has been amended to clarify how defaults are remedied. Clause 8.3.1 applies where the Licensee has failed to provide adequate security and so the other licensees have had to make up the shortfall in that security – in particular it clarifies that, to remedy this, the defaulting licensee must pay the shortfall into its own account and the interest to the Non-Defaulting licensees. There is then more specific provision for the Non-Defaulting Licensees to be repaid out of their trusts the amount they have contributed towards the shortfall. The concept of an Augmented Share has been introduced to provide a convenient term to describe the proportion of any payment to be paid by a Non-Defaulting Licensee which results from the division of the Defaulting Licensee's interest across the Non-Defaulting Licensees in proportion to their beneficial interests. For example, if there are four co-venturers in a field, each with a 25% interest and one defaults, the Augmented Share of the three which remain is 33.33%.
- 9.5 Clause 8.3.2 applies where the licensee defaults in relation to settlement of a decommissioning invoice. In a pre-tax world, since the trust will contain full security, then provided any shortfall in security has been made up (under Clause 8.3.1) the operator will be able to fund decommissioning invoices from the trust in the event of a default. However, in a post-tax world, even if the trust is fully paid up, if there is a default the trust cannot meet the full cost of an invoice as it contains only the post-tax value of a Licensee's share of decommissioning costs. The other licensees must therefore provide the Tax Relief Element and then reclaim that through the tax system or under the DRD, as only the post-tax value of a decommissioning invoice will be paid out of the trust of the defaulting licensee (see section 10.2). Such amounts are stated to be debts owed by the defaulting licensee to the non-defaulting licensee and this default may be remedied by payment of those debts plus interest. The wording in Clause 8.3.2(a) has to cater for a default by the licensee under either Clause 9.2 or 9.3. In either case, what the operator needs is payment of the outstanding part of the invoice which has not been received from either the licensee direct or the trust. In the case of a default under Clause 9.3.5, the wording tracks exactly the wording in Clause 8.3.2. In the case of a default under Clause 9.2.2, where the Licensee was due to pay the whole invoice, the post-tax part will come from the trust and therefore the outstanding part will be the tax relief element – it is the latter which is therefore referred to in Clause

9.2.2(b), but for the purposes of Clause 8.3.2 this is the outstanding part of the invoice.

9.6 In both cases, once the defaulting licensee's interest has been forfeited, it is too late to remedy as it would be too complex to unwind the forfeiture.

9.7 Clause 8.4.6, which deals with the obligation of a Defaulting Licensee to reimburse the Non-Defaulting Licensees for any cost overruns beyond the security provided has been amended to take account of the fact that the Non-Defaulting Licensees will also have received tax relief or DRD payments and therefore such reimbursement should only reflect their net loss.

10. Payment out of the trust

10.1 The other area of the DSA which has undergone substantial change as a result of the introduction of DRDs is the section dealing with payments out of the trust. In a pre-tax DSA where the licensee has paid cash into the trust the operator will automatically take the full value of the invoice out of the trust. If the licensee has provided Alternative Provision the licensee will be given an opportunity to pay the invoice and only if it defaults will the Alternative Provision be realised. In a post-tax security situation there is in all cases a requirement for some payment by the licensee – even if the licensee has provided cash into the trust, it will still need to pay direct to the operator the tax portion of the invoice (defined as the "Tax Relief Element") since the trust only contains the net amount (the "Post-Tax Value" – see further at paragraphs 10.5, 10.8 and 10.9 below).

10.2 A licensee must therefore decide how to meet an invoice from the operator. Where there is cash in its trust fund it can choose to have the operator take that cash to pay (or part pay if the security is on a post-tax basis) the invoice – this is so whether the cash is in the trust as a result of the licensee's choice or as a result of an earlier default which resulted in the Alternative Provision being realised or otherwise. If the DSA is operating on a post-tax basis it cannot of course ask the operator to take more than the Post-Tax Value of the invoice out of the trust, nor can it ever ask the operator to take more cash than is in the trust. Alternatively, it can choose to save some or all of its cash for another day and to pay more of the invoice itself – however, the minimum it must pay the operator in a post-tax situation is the Tax Relief Element. The amount the licensee elects to pay is the "Non-Trust Portion" of the Invoice and in most cases this will equal the Tax Relief Element. The amount remaining to be paid will be the "Trust Portion" of the Invoice and in most cases will equal the Post-Tax Value (Clauses 9.1.2 and 9.3). If the trust contains only Alternative Provision then the situation is similar to the present situation, in that the licensee will be expected to pay the invoice in the first place but if it fails the Alternative Provision will be realised (Clauses 9.1.1 and 9.2).

10.3 If a licensee has paid an invoice directly to the Operator, it may be reimbursed out of the Trust Fund but where security is given on a Post-Tax Basis, only up to the Post-Tax Value (Clause 9.7).

- 10.4 [Changes also needed to be made when it comes to reimbursement of other parties who have paid for decommissioning after a default.] Where security is provided on a post-tax basis, then, in relation to any invoice for decommissioning costs, the template DSA needs to specify that the payment out of the trust can never exceed the Post-Tax Value of that invoice (Clause 9.3.3 or Clause 9.2.2), and that such payments will be deemed to be payments made by non-defaulting licensees to allow the non-defaulting licensees to claim the tax relief. This deeming is required to address the fact that, in a default situation, the Post-Tax Value of an invoice will be met out of the trust of the Defaulting Licensee (therefore not paid directly by the non-defaulting licensee), but the tax relief portion of the invoice will be paid by the non-defaulting licensee. As a party can only claim tax relief on decommissioning costs it has actually paid, it is important to make clear on whose account the amount paid out of the trust has been paid (for the purposes of claiming tax relief). Clause 9.4.3 goes on to provide that where a non-defaulting licensee receives tax relief (or payment under a DRD) then to the extent they have been over-compensated they will return the excess amounts to the trustee of the defaulting licensee - this is on the basis that the non-defaulting licensee will have received 100% compensation (out of the defaulting licensee's trust and the tax relief) so any excess should be returned to the party that funded out of its trust.
- 10.5 To facilitate these provisions the operator will need to indicate the Post-Tax Value on the invoice issued to a licensee (noted in Clause 9.1). This calculation is set out in Clause 9.18 and is essentially the same calculation as the calculation of the overall security, but applied to a smaller number and the bridge finance amount will only be applicable in certain circumstances – see further at paragraphs 10.8 and 10.9 below. The other critical difference is in relation to PRT. The rate of RFCT/SC to be taken into account by any post-tax DSA is essentially fixed by the DRD at 50%. However, PRT rates can change – the rate applied to calculate the security is in effect an average of all of the rates which are applicable, or are expected to be applicable, to those profits against which decommissioning expenditure is likely to be relieved. However, when a particular invoice is paid by a licensee (whether its own expenditure or expenditure it is incurring as a result of a default) it will not get an average rate of relief but a specific rate of relief. This may be higher or lower than the average.
- 10.6 The template DSA could have applied the same average rate of relief to the invoice as was applied to the calculation of security but that would have produced inconsistent results and might be complex to try to reconcile later in the process. Instead, the draft proposes to try to pay out the actual rate of relief which is expected to be applied to the invoice. Even this cannot be entirely accurate as shown by the following example. The operator is producing an invoice for decommissioning costs in October 2013. In order to apply the correct rate of tax relief the operator will need to know what rate will be applied by HMRC to losses incurred by the relevant licensee in the period from June to October 2013. However, the most recent HMRC Certificate the operator will have at that point will relate to the period from January to June 2013, and even that will not be firm as regards that period but will only specify the available profits for that period on the basis of the submissions of the taxpayer, as these will not be assessed at that point. The only firm information is likely to be for the period from June to December 2012. However, provided it is clear that oil

allowance is not in issue, in many cases the relevant tax rate will be capable of estimation with a reasonable degree of accuracy. In some cases the rate may be incorrect and in those cases the template DSA contains various corrective mechanisms:

10.6.1 If too much tax relief is given, the licensee must repay the difference

10.6.2 If too little tax relief is given, the allocation claims process at Clause 9.13 allows a non-defaulting licensee to claim the excess.

Since this is only a estimate, in cases where to calculate the Post-Tax Value on a last in, first out basis for individual invoices is felt to be too administratively burdensome, the template DSA provides that the Decommissioning Plan can propose an alternative – this might involve assuming a particular rate of relief for a licensee for a six month period, or for all expenditure up to a particular value.

10.7 To address this issue to some extent, Clause 9.6 provides for any additional amounts received by a licensee by way of tax relief or payment under a DRD, to provide these additional amounts back into the trust.

10.8 The circumstances envisaged in paragraphs 10.2, 10.3 and 10.5 above all relate to payment by a licensee of its own decommissioning costs and accordingly the bridge finance amount should not be applicable when calculating the Post-Tax Value. Therefore Clause 9.18.1 will be the applicable clause to use when calculating the Post-Tax Value in relation to the operator advising the Post-Tax Value of the invoice (Clause 9.1.), in determining the trust portion of the invoice to be paid out of the Trust where the (non-defaulting) licensee has made an election to pay part of the invoice out of its Trust (Clause 9.1.2(c)) and in relation to a reimbursement from the Trustee if a licensee pays its invoice in full (Clause 9.7).

10.9 Clause 9.18.2 will be used to determine the Post-Tax Value of an invoice or payment in all other circumstances and will include the bridge finance amount (as envisaged at paragraph 10.4 above, but also in all other scenarios not specified in Clause 9.18.1). This means that the Type I Notice served by the operator will include an element of bridge finance in relation to that particular invoice and thus reduces the outstanding amount of the invoice to be made-up by the non-defaulting licensees. Therefore the principle reflected in paragraph 9.18 that the bridge finance amount should only be paid out of the Trust if a non-defaulting licensee (or Second Tier Participant/Third Tier Participant/Secretary of State) has had to pay someone else's decommissioning costs.¹⁴

¹⁴ It has been considered, in circumstances where a licensee is providing security by way of cash to the Trustee (or if cash is already sitting in the Trust as a result of a previous default), whether the associated bridge finance amount should be paid out at the time the invoice is to be paid rather than that amount having to remain in the Trust until the End Date. This is considered to be a commercial point which is likely to make very little difference in practice (as it is anticipated that in the vast majority of cases invoices will be paid in full directly by the licensee), but something which parties could provide for if they so wish and if considered relevant to their particular joint venture.

- 10.10 Some of the processes involved under the template DSA involve estimates – the bridge finance factor is an estimate of the financing costs which a party will incur and, in the case of PRT fields, the Post Tax Value is an estimate of the tax relief it will achieve. A process has been included to ensure that, whatever happens, parties which have incurred decommissioning costs as a result of default are not left out of pocket to the extent that there is still money in the trust at the end of the day, for instance as a result of an unused risk factor element. A process is set out in Clause 9.13, first for the parties to agree a re-allocation of payment among themselves and, to the extent that this is not successful in resolving all claims, to allow the operator to authorise payment of claims out of any remaining funds in the trust of the defaulting party after the End Date, when all base decommissioning costs have been settled.
- 10.11 Clause 9.13.3 provides in effect that no party should be claiming under this process an amount which they are entitled to claim under their DRD unless they have made a claim, the period for payment under the DRD has passed and they are still out of pocket
- 10.12 Clause 9.14 has been amended to postpone the End Date (and the return of any remaining funds to the Defaulting Licensee) until the process under Clause 8.8 has been completed.

11. Appendix 5, para 6

- 11.1 The calculation of TR is set out in Appendix 5. TR is an amount (not a rate) of tax relief which the parties can expect to receive in respect of the Licensee's share of Decommissioning Expenditure based on the guarantee given by the Government in the DRD.
- 11.2 Note that Decommissioning Expenditure could potentially vary from Net Cost – Net Cost is the total cost of decommissioning (ignoring tax relief). It is widely defined. Decommissioning Expenditure represents the costs of decommissioning which are allowable for tax purposes within the DRD. The definition is frozen to prevent the costs subject to relief being narrowed by the Government but this also prevents the costs being widened to include this new class of expenditure. The definition of allowable decommissioning expenditure for tax purposes which applies for the purposes of the DRD (being the definition as at enactment of Finance Act 2013) has been designed to cover all known categories of offshore expenditure but it is possible that in future a class of expenditure may arise which is outside that definition. In such a situation, security would still need to be provided in relation to that new class of expenditure as it would be part of Net Cost. However, paragraph 6.2 has the effect of excluding that class of expenditure from the calculation of TR.
- 11.3 TR is calculated on Decommissioning Expenditure uplifted by the risk factor – this is achieved for PRT at step (v) of Method A1 (Option 1), step (vi) of Method A1 (Option 2), or (ii) of Method A2 and for RFCT/SC in the formula at B (ii).
- 11.4 PRT relief (where applicable) is calculated at Section A and RFCT/SC relief at Section B.

- 11.5 PRT Relief is guaranteed by the Government on the basis that a party taking on the liability of a defaulting party will obtain at least the tax relief which that defaulting party would have obtained. Therefore when calculating security to be provided by licensee A, the relief to be taken into account will be based on licensee A's PRT Certificate – if licensee A defaults, any licensee taking on its liabilities will be able to claim based on A's history. It should be noted that (as discussed above at section 6.6) the PRT Certificate is merely a snapshot of that history and not a guarantee that the tax capacity as shown in the Certificate will be available at the time of default – it may have been affected by loss carry back claims. This risk is addressed by some of the provisions of Clause 3.1. Nonetheless, for the purposes of calculating security, the PRT Certificate is the starting point. The PRT Certificate will show for each historic Chargeable Period the amount of Available Profits against which losses may still be set and the rate at which tax was paid on those profits and therefore the rate of relief available for losses set against those profits. The PRT Certificate will show sufficient periods to cover the anticipated costs of decommissioning and a risk factor.
- 11.6 There are two options for calculating PRT Relief – parties may elect to use either (A1), a precise calculation based on individual PRT Certificates or (A2) a more “broad brush” calculation which assumes a standard rate of PRT Relief for all licensees. Both options may be left in the DSA and A1 will apply unless there is unanimous agreement to use A2 – that option is likely to be agreed in respect of any Relevant Year only where all licensees are comfortable that there is either no PRT capacity (resulting in an effective rate of zero) or so much capacity since the end of oil allowance that all licensees are likely to achieve a rate of relief of 50%.
- 11.7 If Method A1 is selected, a decision must then be taken as to the circumstances in which historic Available Profits should be augmented by future profits/losses to calculate available tax relief. Depending on the exact circumstances of a field, this might result in the PRT tax relief obtained on decommissioning expenditure being higher, lower or unchanged compared to the tax relief on existing historic Available Profits, with an associated impact on the security amount.
- 11.8 Within (A1) there are two possible methods of calculation and it is expected that parties will include only one of these in their DSA. The two methods are essentially the same but in Option 1 for (A1) the amount of PRT Relief allowed in the calculation is calculated twice, once with Tax Capacity based on projected income and once without, and the lesser amount then used to calculate TR. In Option 2 for (A1) the amount of PRT Relief allowed in the calculation takes into account projected income at all times when projected income (Net Value in the form of factor Z) is also taken into account in the security calculation but not otherwise (see section 11.10 for further detail). In each case Decommissioning Expenditure (increased by the risk factor) is set against each tranche of those Available Profits in turn on a last in first out basis and the relief obtained for each tranche is added together to determine the total tax relief achievable for a given quantity of decommissioning.
- 11.9 The first method results in projected income being taken into account in the calculation of available tax relief only if it would result in reduced relief and therefore increased security. The second method takes projected income into

account in the calculation of available tax relief whenever it is used in the calculation of security regardless of whether it would result in increased, decreased or unchanged security.

- 11.10 Clause 6.1 contains an option to exclude Net Value in the form of factor Z from the security calculation when there is a single remaining licensee – this is on the basis that in such a situation there is no other licensee able to exercise rights of forfeiture and therefore gain the benefit of that Net Value. In addition, if there is only one remaining licensee and that licensee becomes insolvent, there must be a significant risk that the remaining reserves will not in fact ever be produced and therefore the projected income and associated tax relief will never be realised. The second method therefore excludes projected income in the tax relief calculation if Net Value is excluded from the security calculation. The first method takes account of projected income in all cases. If future PRT rates are lower, the first method will reduce the tax relief in the calculation accordingly (even though in the case of a default by a single licensee there is a risk that the future income may never be realised). Security will therefore be higher. However, in such a case, if future income is no longer taken into account in the calculation, security calculated under the second method should still be adequate if the future reserves are not in fact produced, as costs will still be set off against historic production.
- 11.11 The method of calculating for RFTC/SC Relief is far simpler. The Net Cost is multiplied by the Risk Factor. The Allowed PRT Relief is deducted and the resulting figure multiplied by the rate of relief guaranteed by the DRD.