# Revisions to Inflation & Discounting Methodologies

## Background Information

The UK has experienced significant levels of inflation during the period 2021 to present, with resulting increases in UK interest rates. The previous model form Decommissioning Security Agreement (“DSA”) does not structurally connect the macro-economic basis of the life of field forecasts used for 1) revenue inflation, 2) cost inflation and 3) discounting in the Net Value and Net Cost calculations.

1. Per the model form DSA, long run revenues are inflated on a forward-looking basis, using average WoodMac long run inflation assumptions (typically 2%, developed with reference to Bank of England inflation target).
2. Per the model form DSA, long run costs (Opex, Capex, Abex) are inflated on a backward-looking basis, using a 3 year average UK PPI lookback.
3. Per the model form DSA, long run discount rates can be set by reference to a backward looking 3m / 12m SONIA interest rate. Alternatively, forward looking UK gilt yields can be used.

OEUK initiated a Task Finish Group (“TFG”) to assess the potential impact of the above on UK DSA postings. The TFG was composed of 13 UKCS upstream companies representing a broad cross-section of industry.

## TFG – Findings

The following Problem Statement was agreed by the TFG:

1. Current exceptional macro-economic circumstances mean that the industry standard DSA approach to determining inflation assumptions (average over previous 3 years) and discount rate assumptions (interest rate/gilt yield on specific date) is unlikely to be representative of credible long-run trends; an alternative industry approach is proposed to arrive at more appropriate assumptions to avoid significant over-provision of security.
2. Over-provision of security is anticipated to reduce debt capacity within industry, potentially resulting in reduced UKCS re-investment; and potentially elevating risk of default (with potential cross-industry domino effect) due to inability to meet increased DSA security demands.
3. It is proposed that the TFG undertakes a balanced approach to exploring opportunities to mitigate the risks above; and proposes viable solutions that are implementable within a reasonable timeframe; whilst always ensuring that DSA safeguards continue to provide adequate protection for all stakeholders as envisaged in the previous model form DSA.

The TFG assessed a number of different scenarios using illustrative oil / gas field examples. The structural disconnect between the previous model form DSA methodologies to inflate revenue / costs and incorporate discounting was confirmed. The TFG confirmed that the previous model form DSA methodologies create a short to mid-term risk of both over and under securitisation due to combining forward-looking (revenue inflation) and backward-looking (cost inflation, discounting) assumptions. The TFG also confirmed that previous model form DSA inflation / discounting methodologies create risk of year on year volatility / unpredictability in the level of security posting required.

It was recognised by the TFG that ultra-late life assets, and assets that have already reached Cessation of Production (“CoP”), are deemed to be generally less exposed to under / over securitisation risk (as a result of previous model form DSA inflation / discounting methodologies) due to shorter time horizon to conclusion of final decommissioning. The previous model form DSA inflation / discounting mechanisms (as set out below for information) may still be deemed appropriate by such JVs.

*Inflation – Previous Methodology*

*“The annual rate of inflation shall be equal to one third of the sum of the annual percentage increases in the Producer Price Index over the three (3) year period ending on the 31st March in the Year of calculation. The “Producer Price Index” for the purposes of this Paragraph 3 shall mean the index called (JVZ7) – Output of manufactured products (revised definition 2007 SIC) (exclusive of VAT and any tax analogous thereto) as published by the UK Office for National Statistics in Business Monitor MM22. If the UK Office of National Statistics ceases to exist or ceases to publish the above mentioned index, the Parties shall agree a replacement assumption, and if they fail to do so, any such Party may refer the matter to an Expert under Clause 11.”*

*Discounting – Previous Methodology (SONIA alternative)*

*“SONIA Compounded in Arrears from [[1st April] in the Year immediately preceding such Year/[1st January]] to [31st March] in such Year, or other such [twelve (12)/three (3) Month] period as may be agreed amongst the Parties, on an after Tax basis, where such effective tax adjustment reflects the expected tax treatment of funds and the income arising from those funds, as if such funds were placed on deposit by the Trustee at such SONIA Compounded in Arrears rate from the Relevant Year and remitted in the Year of the respective cash flow to be discounted (such Tax adjustment, without limitation, to reflect the impact of corporation tax, income tax and inheritance tax).”*

A number of alternative inflation and discounting methodologies were screened, considering following criteria:

1. Does the methodology economically address the issues set out in the Problem Statement?
2. How viable would the methodology be to implement: likelihood of achieving TFG consensus, likelihood that changes will be subsequently adopted by JVs, and extent to which options can be considered ‘dispute-proof’?

Recommended Revisions to Model Form DSA

The TFG recommends aligning the basis of revenue and cost inflation, and discounting, to be forward-looking. It is recommended that cost inflation in the model form DSA is transitioned to a forward-looking MPC Forecast / BoE target basis, and that backward-looking SONIA discounting option is removed from model form DSA (and with corresponding removal of recommended 100-150 basis point uplift of UK gilt yields).

|  |  |
| --- | --- |
| **Clause in DSA** | **Drafting** |
| Appendix 5 – Article 3.0 | The annual rate of inflation shall be equal to:  (a) for the Relevant Year and the Year immediately succeeding the Relevant Year (“RY+1”), the annual UK Consumer Price Index inflation forecasts published during the first quarter of the Year immediately preceding the Relevant Year by the Bank of England Monetary Policy Committee in its Monetary Policy Report central projection for CPI inflation (the “First Quarter MPR”), such CPI inflation forecasts for the Relevant Year and RY+1 being the average of the CPI inflation forecasts published in the First Quarter MPR for (i) in respect of the Relevant Year, each quarter in the Relevant Year; and (ii) in respect of RY+1, each quarter in RY+1; and  (b) for the Year immediately succeeding RY+1 and for each subsequent Year, the inflation target rate set by the UK Government in the monetary policy remit correspondence (as published by the Bank of England) and in effect immediately prior to the time of calculation of Net Cost and Net Value hereunder.  If the Bank of England ceases to exist or ceases to publish the above mentioned forecasts and/or the UK Government ceases to set the above mentioned target rate, the Parties shall agree a replacement assumption, and if they fail to do so, any such Party may refer the matter to an Expert under Clause 11.  A footnote will be added:  *See Guidance Note – For the Year immediately succeeding RY+1 and for each subsequent Year, Parties may also wish to consider the relative merits of using published UK inflation forecasts from alternative sources such as WoodMackenzie or Economist Intelligence Unit. For assets in late life / post CoP phase, it may be appropriate to utilise backward-looking UK PPI average inflation as published by the UK Office of National Statistics.* |
| Definition | “Discount Rate” means with respect to any calculation of Net Cost or Net Value being conducted in any Year:  the annual post-Tax redemption yield (at the rate at which the income held under the Trust Deed would be taxed) of a fixed interest security which is issued or unconditionally guaranteed by the UK government having a final maturity during the three year period commencing on January 1 of the Year in which Decommissioning is to commence, (or if Decommissioning has already commenced, during the next three year period of the Decommissioning yet to be undertaken) such redemption yield being obtained from the Bank of England on [31 March] in such Year (or if not available on such date, on the first date thereafter on which it is available) or if such yield is no longer reported by the Bank of England, the yield as reported by another reputable source of financial data agreed between the Parties, or in default of agreement, decided by an Expert to whom the matter shall be referred by the Operator  A footnote will be added:  *See Guidance Note – for assets in late life / post CoP phase, it may be appropriate to utilise backward-looking SONIA interest rates as an alternative to gilt rates* |

## 

## Implementation - Considerations

The recommended revisions to model form DSA above are always advisory in nature; individual JVs will require to consider the merits and risks of adopting any formal DSA amendments giving due consideration to the asset-specific characteristics on a DSA by DSA basis. The TFG recognises that, for ultra-late life assets and assets that have already reached CoP, the risks of under and over securitisation associated with retaining the previous model form DSA inflation / discounting methodologies are generally lower than assets with longer predicted economic lives.