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# Memery Bank

## Access to Offshore Infrastructure: Is ICoP Enough?

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Sean Rush examines the effectiveness of the Infrastructure Code of Practice as a means to regulate the use of offshore facilities by third party users.

### INTRODUCTION

In 2004 the UK oil and gas industry adopted a Code of Practice for third party access to infrastructure known as the Infrastructure Code of Practice ('ICoP'). Its purpose is to facilitate the utilisation of infrastructure for the development of remaining United Kingdom Continental Shelf ('UKCS') reserves through timely agreements for access on fair and reasonable terms, where risks taken are reflected by rewards. By their endorsement of the ICoP, parties make a commitment to be guided by its principles and procedures.

However, in its 2008-2009 report, the House of Common's Energy and Climate Change Committee (the 'Select Committee') concluded that:

***'Smaller companies in particular are having difficulties accessing the infrastructure they require in order to produce oil and gas because in some cases of unrealistic demands by the infrastructure's owners. The industry's voluntary Code of Practice is not working well in this respect [sic]. If a voluntary code cannot be made to work more effectively serious consideration should be given to introducing a common carrier system.'***

This paper examines the effectiveness of ICoP as a means to regulate the use of offshore facilities by third party users. It reviews its success or otherwise as a tool to facilitate the extraction of the remaining reserves on the UKCS and considers alternative structures including the applicability of a common carrier system.

### THE INFRASTRUCTURE CODE OF PRACTICE

#### **Background**

Historically oil and gas reserves on the UKCS have been extracted by private consortia holding the applicable upstream petroleum production licence. Production required the construction and development of 'stand alone' offshore production facilities that were connected by pipelines to onshore processing terminals where the resultant products were made available for delivery to market. As capacity became available in the facilities, it became common to connect or 'tie in' new, and sometimes third



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party owned, fields to either the offshore facility which would link to a pipeline system (an 'Entry Node') or direct to the pipeline system (a 'Third Party System') thereby utilising the otherwise sterilised capacity and saving the new field owners the considerable cost of constructing new infrastructure and replicating the export system.

Such arrangements have been the subject of bilateral contractual negotiations involving the provision of a range of services on a long term life of field basis and would include transportation and processing of production (a Transportation and Processing Agreement or 'TPA'), and, on occasion, the day to day management of the new field, or 'operator' services (a Transportation, Processing and Operator Services Agreement or 'TPOSA').

Such services would be paid for by a mixture of cost of service charges, a per barrel tariff with any facility modifications required being for the account of the new field owners.

In 2005 the PILOT Brownfield's study noted that in order to maximise the recovery of reserves from the UKCS the ongoing availability and maintenance of infrastructure would be critical. It stated that:

'The key challenges to extending the life of infrastructure are:

**Maintain/increase throughput & revenue**, attracting further infrastructure usage e.g. through effective implementation and usage of the Infrastructure Code of Practice, ICOP'.

However, in 2009, the Oil & Gas UK co-chairs restated the challenge:

'The clock is ticking and, as decommissioning of mature assets advances, so too does the risk that small satellite reserves will remain unexploited if the infrastructure they will have to depend on is removed.'

As a result the future of the UKCS is highly dependent on the successful implementation of ICoP as the tool to regulate the owners of offshore infrastructure with respect to the development of third party fields.

### **Legal Regime**

The construction, development and use of 'stand alone' infrastructure is regulated between owners by their underlying Joint Operating Agreement or 'JOA'. The JOA is an agreement designed wholly to facilitate the joint exploration, production and development of upstream petroleum and suffices to deal, on a collective or 'bundled' basis, with the transportation and processing of production within facilities that are wholly owned under the JOA. Transportation, processing and other services provided on behalf of third parties is arranged pursuant to TPAs and TPOsAs between the facility owners and facility users or, in the context of the Select Committee Report, the "carrier" and the "shippers". These have traditionally been unregulated bilateral contracts for carriage that may be accompanied by a complex suite of ancillary agreements concluded with other shippers.

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The Petroleum Act 1998, the Pipe-lines Act 1962, the Energy Act 2008 and the Gas Act 1995 set out the rights and obligations placed on carriers and shippers with respect to the granting of access to infrastructure under bilateral contracts of carriage. They each provide a similar process in which the Secretary can intervene to determine the terms of access to infrastructure in the event that private negotiations are unsuccessful. In addition, the Competition Act 1998 creates prohibitions on certain conduct, in particular the abuse of a dominant position within a market. Such prohibitions may apply to Third Party Systems and Entry Nodes that provide capacity and processing services within a geographic area due to the large costs to acquire such services independently.

### ***Mechanisms***

ICoP requires infrastructure owners to post non-binding indicative terms for the use of their facilities. Pro forma documentation and streamlined processes are also outlined whereby the parties will agree a timetable and structure for the negotiations for access to infrastructure with the matter being referred to the Secretary pursuant to an Automatic Referral Notice or 'ARN' process being activated if the negotiations have not concluded within 6 months. DECC has posted updated guidance notes on how it would resolve disputes subject to an ARN. In summarising its approach to setting tariffs the guidance states:

'Accordingly, in most cases the terms that would be determined by the Secretary of State are likely to be in line with those that would be offered by infrastructure owners were they to face effective competition from other infrastructure owners who also have sufficient spare capacity to accommodate the hydrocarbons in question.'

Compliance with ICoP and the Secretary's guidelines is viewed as 'best practice' and is additionally designed to provide comfort that principles of competition relating to abusing a dominant position, regulated in this area by the Office of Fair Trading, are being adhered to. If agreement cannot be reached then the Secretary is empowered to direct the terms that access may be granted. Alternatively the OFT may rule certain behaviours as anti-competitive and make similar directions with respect to terms of access.



ICoP recognises that the value of obtaining a determination at the end of a negotiating process may be minimal due to the requirement for certainty before investment is made. As such it seeks to regulate negotiating behaviour from the start of the process by messaging the likely outcome of a regulatory determination by either the Secretary or OFT. Either method of resolution leaves uncertainty because binding terms are determined at the end of the negotiation, potentially after considerable investment may already have been made linking the new development irrevocably to the existing infrastructure. This has been said to 'skew' the negotiations in favour of infrastructure owners and invite them to extract a maximum of economic rent from the development rather than set tariffs reflective of a competitive environment in accordance with DECC guidelines. From a new field owner's perspective uncertainty with respect to key economic terms will militate against investment.

Given the importance that ready access to infrastructure has to the industry it is clear that the Government will take a close interest in ICoP as a means of balancing the interests of stakeholders and look for alternatives if it is not fully successful.

### **Implementation**

The implementation of ICoP has been viewed with limited success. The 2009 ICoP Survey had the following results with respect to compliance with the requirement to post indicative terms:

- (i) Third Party Systems - 31 third party systems were reviewed. 77% of systems have entries on operator websites and 48% of systems have full information provision; and
- (ii) Entry Nodes - 132 entry nodes were reviewed where 41 entry nodes give access to more than one system. 57% of Entry Nodes have entries on operator websites and 20% of Entry Nodes have full information provision.

As can be observed full compliance remains the exception with Entry Nodes in particular lagging.

In DECC's 2008 report dealing with the effectiveness of the Commercial Code of Practice, ('CCoP'), another voluntary code the compliance with which is integral to the proper operation of the ICoP, one conclusion was that:

'The overall picture is that there has not been any significant improvement in commercial performance.'

Other data from the same publication noted incidences of abuse of position and an overall general response from Licensees that improvement would be facilitated by obtaining a 'fair deal'.

Whilst universal compliance seems to be an issue, so too does enforcement. Oil & Gas UK commented that the ARN process that was intended to provide a backstop for failed negotiations was 'not working well' and DECC confirmed that the Secretary had yet to make a determination to date.

DECC 'accepted there were problems with the Code' but the Oil and Gas Independent's Association ('OGIA') which is more representative of smaller organisations wanting access to infrastructure went further:

'The current voluntary Infrastructure Code of Practice (ICoP) is NOT making any significant differences and many bad behaviours and practices still remain. This actively discourages exploration and appraisal for new fields as the risk reward balance is significantly skewed in favour of the infrastructure owner rather than the risk taker. Legislation for guaranteed access terms or 'common carrier' status should be seriously considered.'

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## ALTERNATIVE SYSTEMS

The OGIA's suggestion that guaranteed access terms or a common carrier system be adopted needs to be considered in the light of the present system of bilateral contracts of carriage, as modified by ICoP, and the existing legislation.

### *Common Carrier Systems*

A common carrier, in its purest sense, is one whose rights and liabilities are determined by common law although may be varied by contract. The carrier holds himself out, either expressly or by a course of conduct, as willing to carry for reward, so long as he has room, goods of all persons indifferently who send him goods to be carried at a reasonable price. A common carrier must hold himself out as ready to carry for hire as a business and not as a casual occupation for a particular occasion. If a carrier reserves to himself the right to reject goods whom he is asked to carry according to his usual course of business, or if he carries only certain passengers or goods for certain customers, he is not a common carrier.

The UK's National Transmission System ('NTS') is based on common carriage and recognizes the natural monopoly of a gas transportation system but opens the use of that system on a non-discriminatory basis to all-comers under close regulation. As such, a common carrier system is one where any shipper has an equal right to access and use the system on multi-lateral terms that are non-discriminatory as between shippers.

### *Guaranteed Access Terms*

Guaranteed access terms would require a modification to the existing bilateral contract of carriage system whereby certain terms of the contract of carriage under the TPA or TPOSA are guaranteed as being offered transparently on a multi-lateral basis to all shippers by the carrier. If the present voluntary system is not working then OGIA's suggestion would likely be to make compliance with some or all of ICoP's provisions mandatory with binding tariffs set in line with the DECC guidance.

There is a 'carriage continuum' between unregulated bilateral contracts of carriage at one extreme and a system based on common carriage at the other. In between the two extremes sit both the ICoP system and guaranteed access terms with, respectively, the level of compliance or regulation being determinative of where on the 'carriage continuum' each sits. Determining the optimal point on that continuum to maximise the recovery of the UKCS' reserves and provide appropriate incentives or regulation to move the industry to that point is the underlying issue facing stakeholders.

## APPLICATION TO THE UKCS

Generally there are two types of infrastructure on the UKCS to which ICoP applies: (i) Third Party Systems and (ii) Entry Nodes. There is a difference in the level of compliance with ICoP's publication requirements with nearly half of Third Party Systems being fully compliant but only a fifth of Entry Nodes. Analysing the risk/reward basis for each type of business



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provides an insight into where the incentives for making infrastructure more generally available may lie and consequently where each system of infrastructure sits on the carriage continuum.

### ***Third Party Systems***

Whilst offshore pipelines were designed and constructed to service a specific field or group of fields once production declines then the only manner in which to obtain revenue from such facilities is through third party business as Third Party Systems. As such, many Third Party Systems are reliant on obtaining new business in order to sustain themselves. This is perhaps most obvious with respect to BP's Forties Pipeline System ('FPS') which was built to transport oil from the Forties field to Cruden Bay in Scotland. When Forties' production declined BP sold its interest in the Forties field but kept its interest in FPS, severing its connection with the upstream business and leaving FPS as a stand alone business unit that is incentivised to transport third party production.

Many of the detailed terms of carriage apply multi-laterally in common to all shippers on a non-negotiable basis. As such, FPS is closer to being a common carrier — it is not a 'casual' transporter that undertakes transportation services as ancillary to its main business. The separation of the vertically integrated business in both a financial and legal capacity occurred when Shell sold its offshore Gulf of Mexico gas transmission system to Enbridge Pipelines Inc, a carrier business, with Shell retaining its interest in the upstream fields. With varying degrees, the Third Party Systems have shifted from being connected to their upstream businesses and moved towards being a carrier business whose risks and rewards are based squarely on third party production. This separation of the vertically integrated businesses was undertaken by regulation with respect to British Gas's gas transportation and storage business units and, with the EU's third energy package, is occurring for the rest of the EU's onshore gas and electricity transmission systems and the UK's offshore wind farm regime.

### ***Entry Nodes***

Construction, development and use of Entry Nodes are wholly subject to the risk and reward structure of the upstream exploration and production business and are typically governed by a JOA, an agreement designed to facilitate the joint exploration, development and production of petroleum. The expected return associated with an exploration and production business is based on exploration costs, drilling costs, technical risks and forecast commodity price, in addition to risks that are shared with a carrier business such as maximising throughput, operational reliability and system integrity. As a result, the rewards demanded by the upstream business are much higher than those required by a carrier business and the incentives are very different. Consequently, there is little incentive for owners of Entry Nodes to apply their legal, commercial and technical resources to third party business that may only net a fraction of the return associated with their own equity upstream business. This is apparent from the responses to the CCoP survey where a common problem was the inability to get what third party owners considered a 'fair deal' and that

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infrastructure owners did not commit sufficient resources. The responses demonstrate that barriers to access remain where infrastructure owners want a return in line with their own upstream business before committing resources to attract third party business.

It would appear that those systems with a high level of compliance with ICoP are those whose businesses incentivise them to provide a service that is closer to a common carriage system. Those whose business remain based on upstream production, making third party business 'casual', appear to lag in terms of ICoP compliance leaving the consequent barriers to access.

### **MOVING THE UKCS TOWARDS A SYSTEM OF COMMON CARRIAGE**

Regulated compliance with ICoP and setting of terms could move the industry in the right direction along the 'carriage continuum' by making terms more accessible. However, the challenges of having the Secretary set such terms should not be underestimated. Terms would need to encompass the specific economics of each facility, as understood at the time of development and as varied from time to time due to commodity prices, operational costs, tax changes and the projected value of deferred volumes all of which as adjusted annually. Any attempt to impose a tariff in a vacuum without a bona fide new development scenario is likely to provide a distorted risk and reward structure. Inevitably, any system of imposed terms would be accompanied by appeal rights for the facility owners leading to the same uncertainties already present.

In an effort to avoid prescriptive regulation and allow a market led solution, consideration could be given to unbundling the transportation, carrier, type business from the upstream exploration and production business in order that the correct risk and reward structure is in place to provide appropriate incentives to the owners of infrastructure. Such a shift is apparent with respect to some Third Party Systems. Achieving this shift at the Entry Node level is likely to be more complicated, technically, due to the variety of services that would need to be offered to the shippers, and understandable reticence by owners who will wish to preserve rights in their infrastructure for their own equity production. As a result, fiscal or other incentives would likely need to be offered to encourage infrastructure owners to undertake such restructuring. However, once vertical separation has occurred at a financial level, the resultant carrier would be a separate and self sustaining business unit that could be retained by the current owners and operator or transferred to a wholly separate carrier business who would operate the system as 'System Operator'. Preferential rights of access for owners that are recognised by ICoP could be reserved.

In this manner a market for System Operators would develop creating competition between System Operators leading to a more efficient and competitive service. System Operators would be incentivised to obtain new production, maintain system integrity and provide a reliable and competitive service. Consideration could be given to revenue regulation such

as that applicable to the NTS or price regulation that is more common in the US. With such incentives in place appropriate resources will be allocated to attract new business allowing the market to regulate tariffs based on an appropriate risk and reward structure.



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## CONCLUSION

In order to facilitate the exploration and development of the remaining UKCS reserves, access to infrastructure needs to move closer to a system of common carriage to encourage investment. Regulated or guaranteed access terms will inevitably prove technically complex and subject to appeal. If the existing voluntary arrangements cannot be made to work a market led solution that provides the correct risk and reward structure by the unbundling of the upstream business from the carrier business should be considered.

## About the Author

**Sean Rush** is the head of oil and gas for the London law firm of Memery Crystal. Prior to joining Memery Crystal he was North West European counsel for Petro-Canada. In that role he negotiated and documented the access and use rights of the Triton FPSO for the Clapham, Pict and Saxon fields. He additionally drafted the White Rose Processing Services Agreement, the first TPOSA for the Jean D'Arc basin, East Coast Canada, and also the TPOSA for the Hibernia South extension.

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