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Bridging Valuation Gaps and Other Barriers to M&A in the UK North Sea

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Chrysoar's acquisition follows on from a handful of North Sea assets recently acquired or being acquired by PE portfolio companies. For example, Siccar Point Energy (backed by Blackstone and Blue Water) bought $1 billion worth of North Sea assets from Austrian OMV last year, and similar PE vehicles are also reportedly in talks with Engie, a French utility, regarding its North Sea assets.

The Shell/Chrysoar deal involved a traditional oil company selling to a PE-backed company. This is an unusual, but increasing, pattern. As these types of transactions become more common, the terms on which the parties transacted provide useful insights. The commercial terms may be followed in similar sales in the future.

Future role of PE

The nature of seller and buyer provide examples of the change in composition of participants in the U.K. offshore. Supermajors are exiting a mature basin. With a recently stable oil price, PE is ready to fill the gap. Some view Supermajor divestment as a sign of the decline of the UK North Sea. Others argue that this trend, and replacement by smaller participants with PE funding and an enthusiasm for new developments, may signal a turning point for a beleaguered sector.

In order to maintain levels of production, oil assets require investment from the existing licensees. Despite the United Kingdom having an investor base primarily consisting of "traditional" oil companies, investment has reached record historic lows in recent years. Cash-starved companies have focused finite capital budgets on higher-margin assets in other jurisdictions. As Supermajors now seek to exit the UK North Sea, their replacement PE-backed companies may open up new funding lines that finance project development previously suspended during the oil price slump. Based on current levels of investment in the UK North Sea, proponents of PE argue that diversifying the investor base to include licensees with access to PE lines of funding can only benefit a mature oil basin, such as the UK North Sea.

Traditionally, PE has largely concentrated its investments in onshore United States and other parts of the petroleum value chain. However, PE firms are becoming increasingly active in the upstream sector, both in the United Kingdom and elsewhere. Big brand-name PE houses have raised large funds mandated to make these investments. A significant amount of capital has yet to be deployed.

This trend in upstream investment in the UK North Sea is therefore expected to continue. If this happens, what deal terms can be expected?

Deal terms

Several factors often cited as barriers to merger and acquisition (M&A) activity appear to have been overcome by Shell and Chrysoar. These include valuation "gaps" between buyer and seller, the inclusion of an element of purchase price reflecting a potential production upside and allocation of decommissioning liability. The latter two appear to have been subject to a commercial agreement between the parties.

The transaction may therefore be an example of the terms on which Supermajors are prepared to transact with PE. In Shell's sale, the initial consideration was $3 billion. However, an additional $600 million is payable contingent on the average price of oil between 2018 and 2021 being more than $60 a barrel. This mechanism is an interesting commercial solution for the parties and addresses buyer concerns about investing in higher-cost fields in the current price environment. A further $180 million contingent payment is dependent on future discoveries by Chrysoar and therefore reflects a sharing of any benefits resulting from Chrysoar's future exploration activity.

These types of contingent payments are more often found in development farmouts. During a period of continued uncertainty about the future direction in oil prices, they help bridge the much-cited "valuation gap" that has recently restricted buyers and sellers from agreeing on purchase price.

The deal is also notable in its treatment of decommissioning liability. The head of liability has similarly been considered as a barrier to M&A activity in the North Sea. Shell has reportedly accepted continued decommissioning liability of $1 billion (about 25 percent of the total cost). It therefore reflects a step away from the "clean-break" preference that a seller (particularly, with its negotiating strength, a Supermajor) will walk away from an asset without assuming residual decommissioning liabilities.

We will wait to see whether similar arrangements will be agreed in the future by other sellers wanting to exit UK North Sea.

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