Accounting for Tie-in agreements

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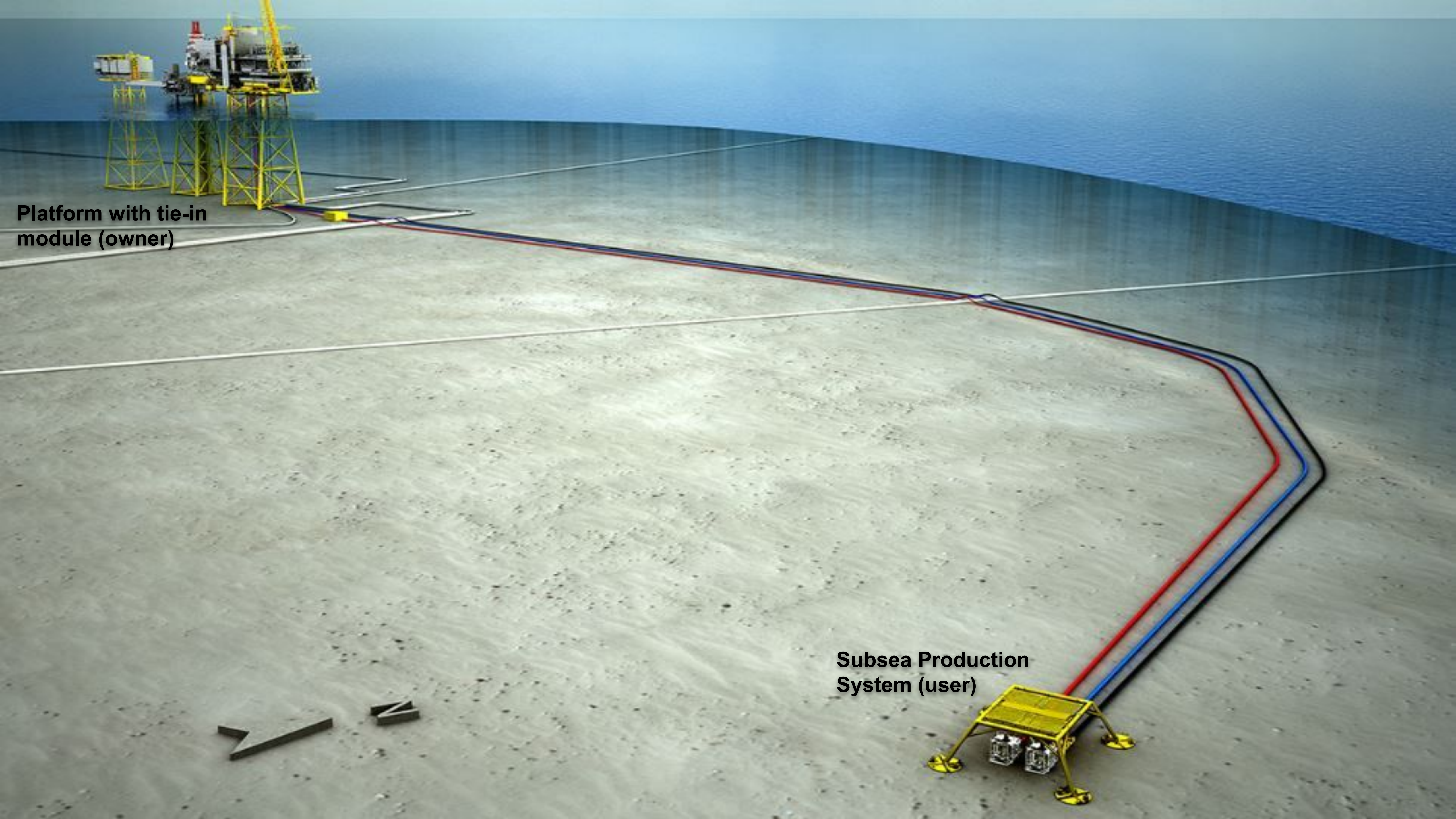
Platform with tie-in
module (owner)
Subsea Production
System (user)
N

Content

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Background

Background

The birth of tie-ins: A politically motivated push

- Year 2000: A continental shelf in decline
- Political incentives to get new actors to the NCS
  - Prequalification system for new partners
  - Reimbursement system
  - Third party regulation

Recent/future tie-in agreements

- Significant increase in number of tie-ins, some recent examples:
  - Dvalin tie-in to Heidrun, Fenja, Bauge and Hyme tie-ins to Njord, Duva tie-in to Gjøa, Maria tie-ins to several host platforms, Vilje tie-in to Alvheim
- Tie-ins expected to be main source of new production on the NCS after Johan Sverdrup
  - Mature infrastructure with spare capacity
  - Developments of marginal discoveries

Accounting for the transfer of assets from user to owner

- Divergence in practice historically.
  - IFRIC 18 was relevant, but is no longer effective after implementation of IFRS 15
- Currently no clear guidelines, complex accounting area and judgement need to be applied

Background - Regulation

Petroleum Act §4-8

- The Ministry may decide that facilities (...) which are owned or used by a licensee, may be used by others, if so warranted by considerations for efficient operation or for the benefit of society, and the Ministry deems that such use would not constitute any unreasonable detriment of the licensee's own requirements or those of someone who has already been assured the right of use.
- Third party Access regulation implemented in 2005 to among other standardize process and reduce time from discovery to production.

Third Party Access regulation ("Tredjepartsforskriften")

- **§2:** Efficient use of facilities in order to ensure incentives for licensees to conduct exploration and production activities with a view to promoting efficient resource management
- **§4**: Right to use infrastructure based on objective and non-discriminatory terms.
  - Profits from production shall primarily be earned by the producing field
  - Tariff shall be based on commercial negotiations
- **§9**: Owner to be held harmless from 3rd Party use of facilities.
  - Reimbursement to owner shall be based on an incremental cost principle
- **§13**: If the Parties does not agree, the disagreement may be sent to the Ministry of Petroleum and Energy for decision.

TERMS AND CONDITIONS FOR THIRD PARTY USE OF INSTALLATIONS ("Standard Tie-in agreement")

- Agreed within the industry and approved by the authorities

Background - Standard tie-in agreement

Incremental costs

- During the investment period, all incremental investments are paid by user.
    - Standard tie-in agreement 4.1:"*The Owner shall, at the User's cost and expense, perform, or cause to be performed, all work related to the Incremental Equipment."*

- Historical pre-investments and opex made for future 3rd Party use will be paid by user
    - Third party regulation §9: "*betaling for eventuelle investeringer i tilleggskapasitet som tidligere er foretatt med tanke på fremtidig tredjepartsbruk, herunder en rimelig andel av risikoen for at tilleggsinvesteringen ikke fullt ut blir benyttet" and "betaling for eventuelle driftsutgifter som eier tidligere har pådratt seg for å opprettholde kapasitet utover eget behov med tanke på fremtidig tredjepartsbruk"*

- All equipment installed at the platform will be transferred to the owner/host at completion of commissioning ("The commencement date")
    - Standard tie-in agreement 9.1: "*The title to the Incremental Equipment shall be transferred from the User to the Owner free of charge upon completion of Commissioning"* .

- Tax values and tax depreciation rights are kept by the user
    - Standard tie-in agreement 9.2: "*The User shall retain the right of depreciation and tax allowances with respect to all investments related to Incremental Equipment and paid by the User in accordance with this Agreement*".

Background - Standard tie-in agreement

Removal

- Owner is responsible for removal of all equipment owned by Owner. However, incremental costs shall be covered by User.
    - Standard tie-in agreement 32.1: "*The Owner shall be responsible for the removal or other disposal of the Owner Facilities and relevant equipment owned by Owner as may be required by applicable laws, regulations and licence terms, and shall bear all costs and expenditures for or related to the removal or other disposal of the same, and shall indemnify and hold harmless the User for costs and expenditures related to such work*."
- Normally settled through a tariff element or upfront lump-sum payment when the owner takes over risk related to decommissioning when ownership of assets are transferred to Owner

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Accounting issues

Accounting issues

How should the transfer of assets from user to owner at the commencement date be accounted for?

- Before the commencement date
  - User recognise assets/prepayments in the development phase
- At the commencement date
  - When assets are transferred from user to owner, several questions arises with regards to accounting for both the owner and user:
    - Should assets received "free of charge" be recognised under IAS 16 and at what value should such assets be recognised?
    - Should transfer of assets from user to owner free of charge be recognised as revenue under IFRS 15?
    - Is transfer of assets in reality a sale - leaseback and should be accounted for as a sale under IFRS 15 and lease contract under IFRS 16?
    - If not a lease, what are alternative accounting treatments?
- After the commencement date
  - Incremental operating costs are included in tariffs and recognised as revenue (owner) and cost (user)

How should the transfer of removal liability from user to owner be accounted for?

- The standard tie-in agreement states that removal of user equipment is under the responsibility of the owner, after the transfer of the assets.
- However, incremental costs are under the responsibility of the user, and as such the user is charged as part of the tariff or lump sum payment for the estimated removal cost.

Accounting issues - Transfer of assets at the commencement date

Should assets received “free of charge” be recognised under IAS 16 and at what value should such assets be recognised?

Probably, but assets should be recognised at fair value

- IAS 16: An item of property, plant and equipment is recognised as an asset if:
  - it is probable that future economic benefits associated with the item will flow to the entity;
  - and the cost of the item can be measured reliably.

- **Future economic benefit**
  - Unclear - judgement required related to what equipment is received and whether any benefit exists for Owner.
    - Owner will receive equipment at commencement, but of equipment will be used by User.
    - Owner might, however, be able to make use of equipment at some point - could indicate a residual value?.
    - Owner will charge a tariff covering incremental costs plus a profit element.
      - Related to services received, and not necessary to the use of equipment.

Accounting issues - Transfer of assets at the commencement date

Should assets received “free of charge” be recognised under IAS 16 and at what value should such assets be recognised?

Probably, but assets should be recognised at fair value

- **Measuring cost**
  - Cost is defined as “*... the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction...*”.
    - Assets are transferred free of charge at the commencement date. However, owner will provide access to platform and will receive equipment which residual value probably is not zero.
  - The cost of the acquired item is measured at fair value, unless the transaction has no commercial substance or the fair value of neither the asset received nor the asset given up can be reliably measured.
    - A transaction has commercial substance if an entity’s future cash flows are expected to change as a result of the transaction.
    - Fair value can be measured both by the fair value of a) the assets given up or b) the fair value of the assets received. The fair value which is measured most reliable is used
      - Cost of development not the same as fair value for owner
      - Judgement required - tariff would not change based on the transfer of ownership of equipment. Residual value obtained after close of User production may be close to zero.

Accounting issues - Transfer of assets at the commencement date

Should transfer of assets from user to owner free of charge be recognised as revenue under IFRS 15?

No - not a contract with customer. However, transfer of assets should be de-recognised at fair value

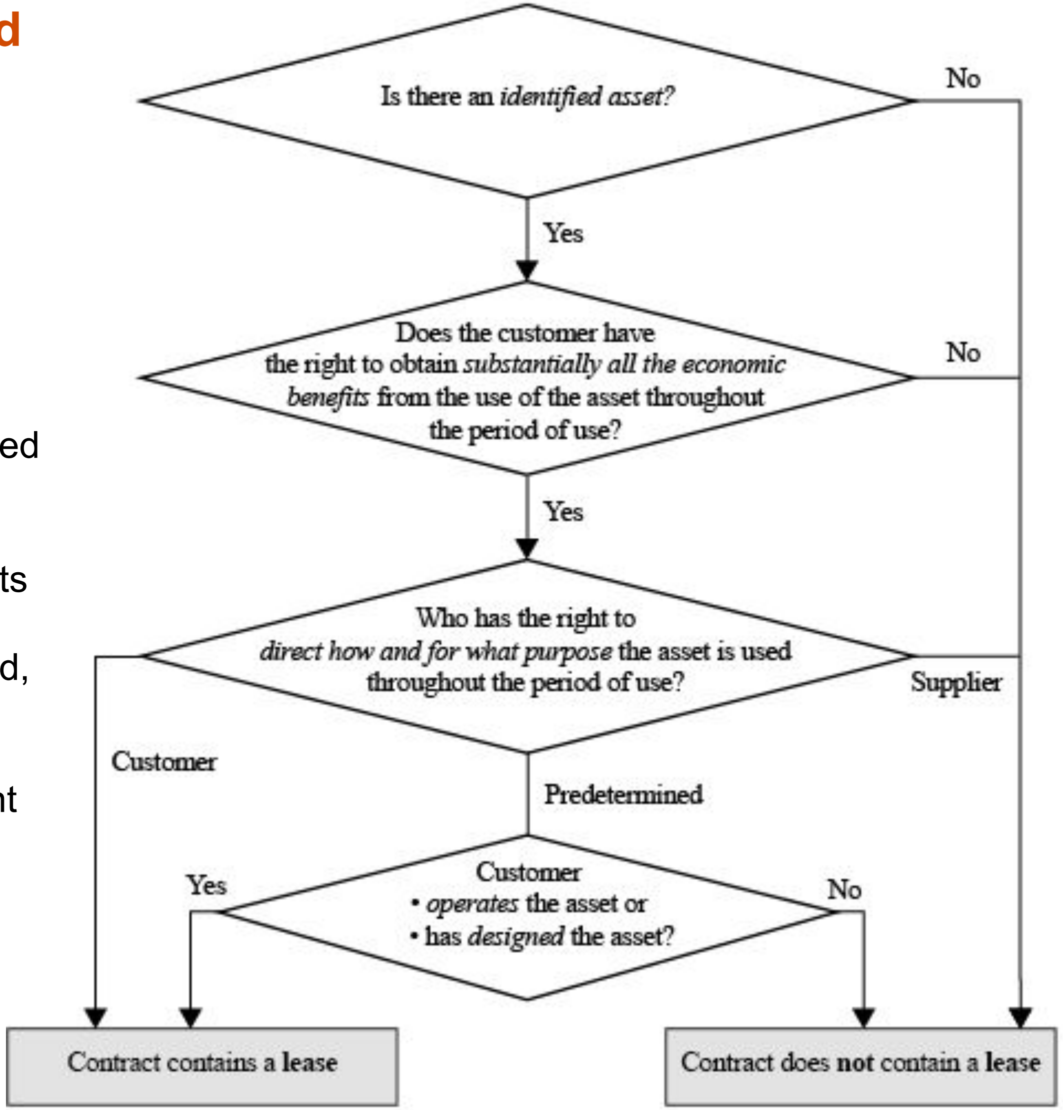
- An entity shall apply IFRS 15 to a contract only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. Tie-in agreements are not part of ordinary activities and as such, IFRS 15 does not apply for such contracts.
- Depending on the initial accounting of development costs, any recognised item of property, plant and equipment should be de-recognised when disposed of. The disposal date is the date when the recipient obtains control of the item, ie at the commencement date.
  - Counter entry may depend on what the rights user has to the assets transferred, and needs to be considered asset by asset
- Non-cash consideration or promise of non-cash consideration is measured at its fair value
  - Presumably the same value as cost incurred on development, which is the fair value for user even if fair value for owner might be different

Accounting issues - Transfer of assets at the commencement date

Is transfer of assets in reality a sale - leaseback and should be accounted for as a lease contract under IFRS 16?

Unclear - depend on facts and circumstances.

- A sale and leaseback is a transaction in which an entity sells an asset and leases it back from the buyer.
- May be relevant dependant on lease criterias and whether right of use of equipment is considered a financial lease under IFRS 16. Following the decision tree in IFRS 16 App B para B31, the following will need to be fulfilled
    - **a)** the assets are identifiable,
    - **b)** user has the right to obtain substantially all of the economic benefits from the use of the assets throughout the period of use,
    - **c)** it is predetermined how and for what purpose the asset will be used, and
    - **d)** user designed the assets.
- Item **b), c)** and **d)** might be challenging, but separate modules or equipment only relevant for user may be defined as sale - leaseback
- Joint investments is not be considered a lease. Lease solution only be relevant for specific investments to be used by User only



Accounting issues - Transfer of assets at the commencement date

If not a lease, what are alternative accounting treatments?

- Old IFRIC 18 solution may still be relevant if the right to use assets does not qualify as a lease, as IFRIC 18 principles are also in line with IFRS 15
- Only cover the accounting for owner (not user)
- IFRIC 18 was issued in response to diversity in accounting practice where entities entered into arrangements where assets was transferred to an entity by its customers. The interpretation considered how an entity should account for assets received from a customer in return for connection to a network and/or ongoing access to goods or services, and was also relevant for tie-in agreements.
- The interpretation stated that the asset should be recognised initially at fair value, in accordance with the guidance in IAS 16 in respect of measurement of a non-monetary exchange, ref previous slide (residual value).
- The corresponding credit was revenue recognised in accordance with the former revenue standard (IAS 18). Revenue was deferred and recognised when the revenue recognition criteria in IAS 18 was met, typically over the useful life of the asset received
- For user, de-recognition would probably be recognised as an intangible asset or prepaid costs and recognised in income statement when used

Accounting issues - Removal

How should removal when settled by tariff element or lump sum payment be accounted for?

- Before commencement date
  - User recognise a decommissioning liability and counter-entry on asset in line with IAS 37 and IAS 16 in development phase for PP&E.
  - No impact for owner

- At the commencement date
  - User: User derecognise the ARO liability for assets transferred to owner. De-recognition is offset against ARO asset.
  - Owner: The decommissioning obligation is transferred to the owner, which recognise an ARO liability equal to the present value of the estimated future cash flows. Counter entry is PP&E if risk for removal is transferred to owner.
  - Lump sum: Prepaid cost by user and deferred income by owner.

- After the commencement date
  - Tariffs
    - User: Payments of tariffs are booked as tariff costs.
    - Owner: ARO asset this is depreciated. Tariff income is recognised as revenue. Net P&L effect dependant on tariff and depreciation.

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Accounting treatment

Accounting Treatment - Different types of incremental costs

Example 1: User specific investments if considered a lease

- Investments into tie-in projects can relate to specific modules/assets. These investments are easily identifiable and cleary separable from the owner/platforms normal operations and serve the users operations.
  - Examples of specific investments: System for measuring volumes, slugging and liquid controllers, valves, specific processing equipment etc.

Example 2: Joint investments

- Part of the investments related to the tie-in might be joint investment with the host. These investments are shared between owner and user based on an agreed upon split.
  - Examples of joint investments: Fire safety upgrades, hub scope, water-injection, separators, heating, chemicals, upgraded IT-systems and storage-tanks

The H25 and M40 modules serving Dvalin at the Heidrun platform

Accounting Treatment - Different types of incremental costs

Example 3: Historical investments paid by user

- User may also need to pay for historical investments by the owner, which were conducted as per building the platform in order to facilitate future tie-ins (typically part of the PDO requirements and specified as part of the PDO)
    - Examples of historical investments: Larger platform, larger storage tanks etc

Example 4: Removal

- Removal obligation of incremental equipment is the responsibility of the user, but is normally transferred to the owner per commencement date, either by including it as part of the tariff or by lump sum payment(s) from user to owner.

The H25 MEG and Methanol utility module (Dvalin) being lifted towards the Heidrun platform

Example 1: User specific investment

Accounting for a specific identifiable investment if considered a lease

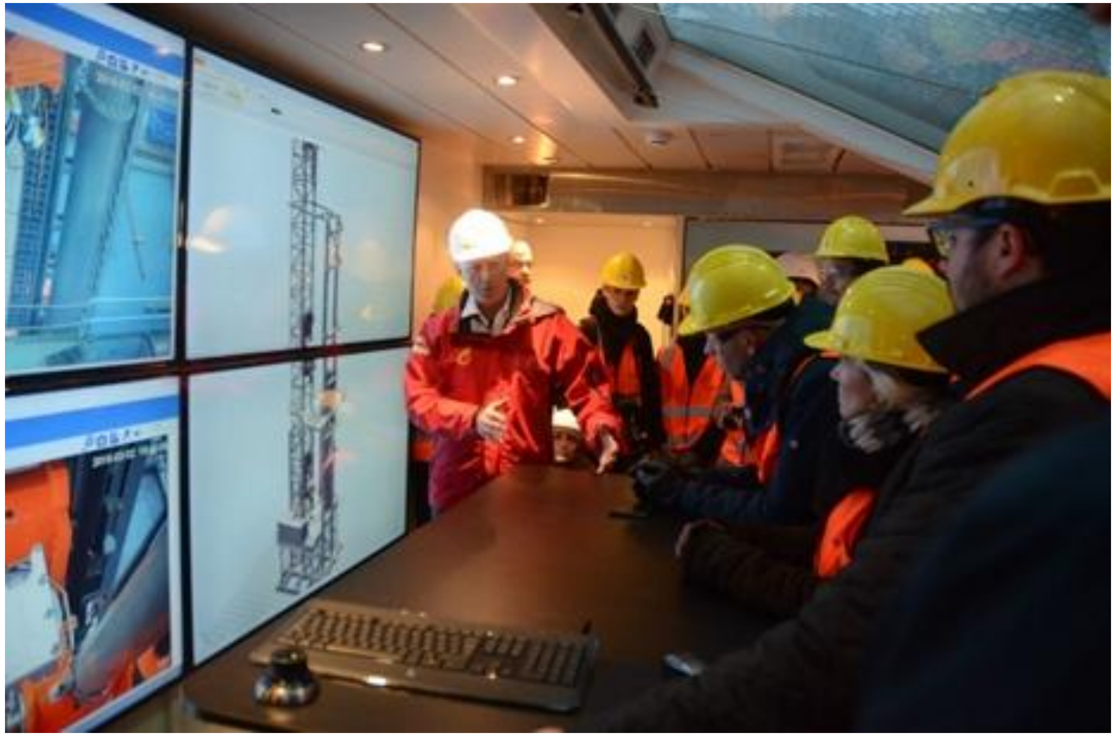
- Under the assumption that transfer of asset qualifies as a sale - leaseback, the following would be accounting treatment:
- User:
  - The seller-lessee measures a right-of-use asset arising from the leaseback, presumably the same value as development costs.
  - Since transfer is “free of charge”, the fair value of the asset is a prepayment of lease payments, and netted against lease liability

- Owner
  - The buyer-lessor accounts for the purchase in accordance with IAS 16, and for a leaseback in accordance with IFRS 16.
  - Fair value limited to residual value for owner after close down of user production?
  - Accounting for the lease as a financial lease would result in a derecognition of the PP&E at the commencement date for the user, simultaneously with the recognition of a ‘right of use’ asset for the same amount.
  - The net investment in the lease would be offset by the liability recognised as part of the recognition of PP&E under IAS 16.

Example 2: Joint investments

Accounting for joint investments or specific investments if not considered a lease

- Accounting would probably follow old IFRIC 18, but other solutions may be relevant depending on the circumstances
- User:
  - De-recognise the PP&E recognised under development, presumably at the same value as development costs, and recognised as an intangible asset or prepayment of costs
  - Charged to income statement over production period (UoP)
- Owner
  - Owner accounts for the purchase in accordance with IAS 16
  - If any assets are recognised, assets are depreciated under the UOP method with other fixed assets



Example 3: Historical investments paid by user

Accounting for historical host investments

- Historical investments has been recognised and deprecated by Owner
- Payment of historical investments may be settled by lump sum payment or as part of tariff costs.
- User:
  - If paid as tariff, user will charge cost to income statement together with other tariff costs
  - If lump sum payment, user will recognise a prepayment which is charged to the income statement when used
- Owner
  - Owner recognised PP&E as part of development historically and has depreciated part of the asset.
  - If received as part of tariff, owner recognise revenue together with other tariff income (no upfront recognition)
  - Any lump sum payment will be recognised as deferred income and recognised as revenue over time

Example 4: Removal

Accounting for transferred removal obligation

- User: The user will derecognise the ARO liability and related ARO asset.
- Owner: The decommissioning obligation is transferred to the owner, which recognise an ARO liability equal to the present value of the estimated future cash flows.
- Payment from user to owner:
    - As part of tariffs
        - User: Payments of tariff included as tariff costs.
        - Owner: ARO asset is depreciated alongside tariff income. Net P&L effect reliant on tariff size and depreciation.
    - Lump sum payment
        - Prepaid cost by user and deferred income by owner.

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Summary

Summary

How should the transfer of assets upon commencement be accounted for?

- It depends.
  - Type of investment, type of asset and whether you are an owner or user.

- Accounting departments need to have a close dialogue with commercial departements
  - Identify all the various investments made and conclude on accounting treatment for significant items

- Develop sufficient accounting memos covering facts and circumstances in new tie-in agreements

For any assistance or questions related to today's topic or otherwise, do not hesitate to contact us

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