

White Paper by WSP Environment & Energy

TRANSFER OF ENVIRONMENTAL LIABILITIES

- A formula for successful divestiture in the oil & gas industry

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With ever evolving markets, the oil and gas industries are rapidly adapting while maintaining their focus on managing their business and assets in accordance with financially prudent protocols. Today, companies are choosing to divest underperforming assets, including the asset's environmental liabilities, to create more attractive property portfolios. Should an asset not align with a company's vision for the future, divestiture or repositioning is vital.

Oil and gas companies have seen an increase in mergers, acquisitions and divestitures over the past two years to reposition themselves to enable an increase in capital spending on exploration and production¹. Repositioning by multi-national oil and gas companies with operations in North America and Europe has become more common due to the shift in energy consumption from the west to the east². It is 60% less expensive to build and 40% more cost effective to operate a refinery in the Middle East than in North America or Europe³. The difference in cost, as well as the consumption shift, is encouraging American and European-based multi-national oil and gas companies to move refining capacity abroad⁴.

Repositioning and divesting often includes sale or transfer of property assets. Due to the nature of the production and distribution processes as well as the age of many oil and gas properties, responsible management of environmental liability is critical when transferring such an asset. Environmental liability can affect the number of viable potential buyers, the value of the sale, or the confidence the seller has that the liability is truly gone. Any or all of these can affect the value of the asset and the management of the liability on the sellers' balance sheet.

The challenge of being an archivist of liability

Environmental liability, regulatory uncertainty, effects of post-sale operations, "bounce-back" of sold properties and uncontrolled division or development of property are all issues that cause multi-national oil and gas companies to become archivists of liability rather than managers of their valuable assets. Holding property that is underperforming or not in production can allow a company to manage its exposure, but it also requires that they bear the property's carrying costs without recovering maximum value from the asset.

However, by managing the liability independent from the transaction itself, companies can unlock the asset value, reduce the carrying costs, and responsibly transfer the environmental obligations. When properly executed, repositioning or divesting an underperforming asset will benefit the seller as long as the sale does not exacerbate the environmental liability.



The environmental balance sheet

The sale of industrial assets, especially those as complex as refining and transmission assets, is an intricate process involving the identification of buyers, engaging operating personnel, engineers, lawyers and auditors to establish the business case for the transaction. Appropriately, the focus is on the asset value, the business history, personnel, taxes, customers, suppliers, permits; essentially, how the transaction will fit with the seller's and buyers' business models. As the deal progresses, both parties will raise the specter of potential environmental liabilities; usually after the business case has been demonstrated.

Both buyers and sellers are encouraged to have a certain level of sophistication around environmental management when engaging in asset transfer.

Basic property transactions are preceded by buyers- or sellers-side due diligence, typically a Phase I Environmental Site Assessment (ESA). A Phase I ESA examines the historical details of the property, searching for any potential liabilities ("recognized environmental conditions"). If this process indicates the need for further examination a Phase II ESA will be performed. Although industry guidance exists for Phase II ESAs, such as ASTM International E1903-97(2002), the scope of Phase II ESAs can be as limited or as in-depth as the initiating party chooses. This practice leaves room for unquantifiable liabilities ("unknowns") which, in a property transaction, can result in underlying liability being discovered further down the road.

Should the parties opt to use an environmental liability transfer solution, both the buyer and seller will be protected from the liability associated with known or unknown contamination. Prior to initiating a liability transfer, an in-depth characterization that explores the impacts of contamination will take place. This detailed analysis of impacted media, in the context of site closure, will help to align the goals of the transaction, minimizing risk for all parties involved.

Notes:

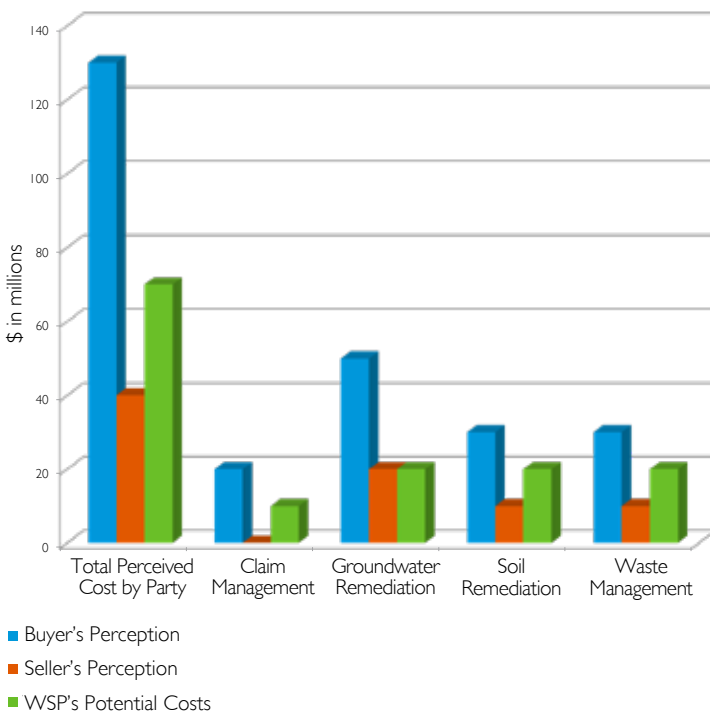
1. M&A Industry Advantage Series – Divestitures and carve-outs in the oil and gas industries. Deloitte Development LLC. Copyright © 2010
2-4. Energy Predictions, 2010- Deloitte Development LLC. Copyright © 2010

Hoping for the best while preparing for the worst

For each party, there must be a balance between hoping for the best while preparing for the worst with regards to environmental response costs. Due diligence helps to narrow the spectrum of risk, however, it is extremely difficult to accurately characterize the full extent of contamination through a Phase I or Phase II ESA; therefore, leaving the potential environmental liabilities on the table. Environmental liability transfer solutions, such as WSP's own Active Transfer program, have the capacity to protect all parties from the entire spectrum of potential risk.

Our Active Transfer program, like any responsible environmental management program, requires a detailed environmental investigation and analysis of an asset; identifying the extent of contamination, defining the program goals, outlining the overall strategy, and setting the baseline against which the seller is protected, and the progress toward site closure is measured. Defining the value of the liability ensures the seller is not discounting the price of the asset too deeply, while the buyer is getting a fair depreciated value for the quantified environmental impacts.

Perception of Total Cost of Transaction by Party



Note: This graph illustrates how each party in a transaction views the total cost of the environmental liability based on observations from hundreds of transactions WSP has supported. We have the tools to manage the program in a manner that ensures fair market value of the environmental liability transaction for all parties involved.



How does environmental liability transfer deliver value?

Liability transfer can be structured to enable multi-national oil and gas companies to unlock the potential value of underperforming properties in their portfolios. WSP's Active Transfer allows the seller to uncouple the asset from the environmental liability. By transferring the environmental liability to WSP, the unencumbered asset can be sold at fair market value. This provides multiple benefits to the seller:

1. The number of potential buyers can be expanded to include companies that can maximize the value of the asset even if they have no appetite for environmental management;
2. The transaction can focus on the business. The negotiation of the asset value without the potentially uncertain range of environmental liabilities is a much more focused discussion;
3. The environmental liability is gone. There is no risk that an upset in a buyers' business plan will divert funds from the environmental obligations to support operations, leaving the legacy to return to the seller. No liability transferred to WSP has ever reverted back to a seller; and
4. While WSP is managing the legacy liability, our engineers and geoscientists will be able to discern any change in conditions due to new operations of the buyer, eliminating the expansion of the risk being managed on behalf of the seller and buyer.

It is not just the seller that benefits:

1. The buyer can focus on the investment without staffing for environmental remediation management;
2. The transaction can focus on the business. The negotiation of the asset value without the potentially uncertain range of environmental liabilities is a much more focused discussion;
3. The environmental liability is gone. The buyer does not have to worry about reserves for liability that is being managed by WSP and funded by the seller; and
4. While WSP is managing the legacy liability, our engineers and geoscientists will be able to protect the buyer from potential claims that conditions, which were simply unknown at the time of the sale, are due to the operations of the buyer. The responsibility for "unknowns" will be WSPs, eliminating the burden of negotiations and potential litigation.

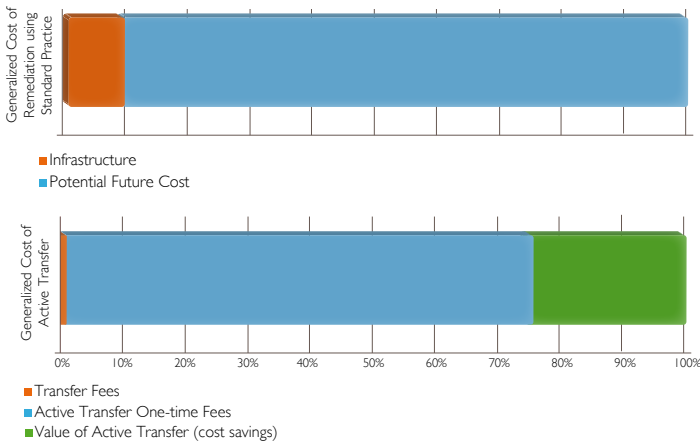
Time is money

Time is money, especially in asset transactions. There are many cases where the sale of a contaminated property has been hindered by: uncertainty surrounding the exact value of liability; concerns about the adequacy of clean-up by a purchaser; and, the companies' view of the likelihood of the regulatory agency requiring a site clean-up, if not already required. Active Transfer "un-hinders" and streamlines the process.

With Active Transfer, we have been able to save clients tens of millions of dollars through efficiency and technical expertise by reducing the cost of conventional environmental remediation. The scenario below shows the percentage of cost savings we delivered to a client using Active Transfer for a site in the United States.

Cost savings result due to:

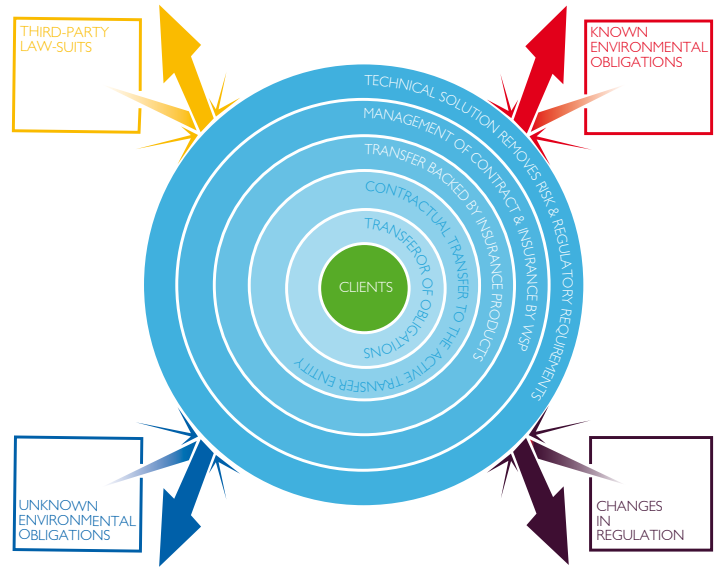
- Implementation of alternative remediation technologies
- Proper scaling of remediation system
- Streamlined process through removing the opportunity for disputes between parties
- Increased efficiency for project initiatives



Note: These savings do not include the savings associated with divesting carrying costs (to the seller), the reduction of management required (buyer), or the capital invested in remediation prior to the initiation of the Active Transfer program. Therefore, the savings are potentially greater than the percentages shown above.

How is the financial structure secured?

In the current market conditions, the ability to quantify and manage liabilities and risks effectively is paramount. A properly structured liability transfer can provide multiple layers of protection for both the seller and buyer. Our approach, establishing a separate entity protected by a trust, is capable of performing even in the event that all parties to the original transaction dissolve.



Above: The layers of protection between our client and the risks associated with an environmentally impaired asset.

Scenarios for Active Transfer

Active Transfer has the ability to bring a client peace of mind by managing their known and unknown environmental obligations, changes in regulation and limiting the exposure to third-party lawsuits. Active Transfer is a favorable solution in a number of scenarios, some of which are described below:

Deadlock in a transaction

Selling an environmentally-impaired property involves negotiations between the responsible party(ies), regulators, buyers, auditors, and lawyers. Buyers often quantify the oversight and management of environmental obligations significantly higher than expected, citing they are burdensome and distracting from the underlying goals of a company. By introducing a third party to accept the environmental obligation, clear ownership of the environmental obligation is established to overcome historic liability chains. Furthermore, the indemnity is transferrable and can follow ownership of the property.

Clean-up balance sheets

Oil and gas companies typically establish financial reserves for environmental obligations at active, inactive or closed assets. Closed or inactive assets are associated with a negative cash flow due to ongoing environmental costs, carrying costs, taxes, insurance, utilities, and maintenance, among other expenditures. Active Transfer can eliminate environmental liability from the balance sheet and cap the cost of managing the liability while transferring the risk. This is accomplished by WSP through accurate and fully auditable estimated reserves for environmental liabilities and added protection above the reserve estimates.

Complex portfolios

A property transaction, including a complex portfolio of sites, carries the risk of improper sale of environmentally impaired real-estate and may put the seller at risk if the buyers are not capable of responsible care. If the buyers opt not to address the environmental issues of a site, obligation may fall back on the seller. Active Transfer can remove the environmental liability associated with the transaction before, during, and after the transaction has taken place, using tailored solutions to each unique property in the portfolio.

Active Transfer in practice

Facilitating Redevelopment in New York

A site-specific transaction company (a Liability Transfer entity) was formed to manage, remediate, and assume liability for the environmental conditions at properties located in a former industrial section of a major city in New York State. The liability transfer structure used protected the sellers, the buyer/developer, and the future occupant of the property against liability for the transferred environmental conditions at the properties.

The Liability Transfer entity was individually established and uniquely tailored to address both the known and unknown environmental liabilities. The buyer and sellers deposited the estimated clean-up funds into two separate independently managed trusts that were used solely for environmental work to be performed at the properties. More importantly, the Liability Transfer entity provided a seamless indemnity to the parties. The liability transfer structure provided a solution that effectively addressed ongoing environmental obligations and enabled the parties to each focus on their core business and contribute to the economic vitality of the community.

A Certificate of Completion was received for the parcel from the New York State Department of Environmental Conservation. The project demonstrated the ability of the liability transfer process to align the interests of the sellers, buyer, developer, municipal government, and state regulatory authority.

Demonstrated success

The ongoing divestiture of underperforming assets seen in the oil and gas industry will be accelerated by environmental liability transfer solutions. In place of a limited number of potential buyers and slow progress toward closure caused by archived liability, a program such as Active Transfer opens up the market by setting a value on responsibly extinguishing the liability independent from the property transaction. Oil and gas companies will benefit from this freedom to transact the asset at a fair market value, confident that their environmental liabilities will not return to surprise them in the future.

Contact Us

For more information on this subject and about WSP's services please contact any of our specialist advisors:



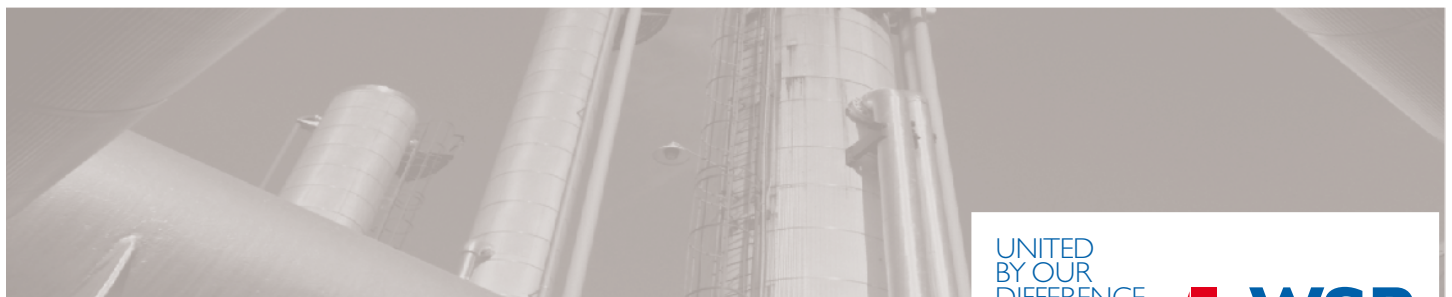
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